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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1929

No. 250

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

OX FIBRE BRUSH COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR CERTIORARI FILED JULY 15, 1929
CERTIORARI GRANTED OCTOBER 21, 1929

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1929

No. 250

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

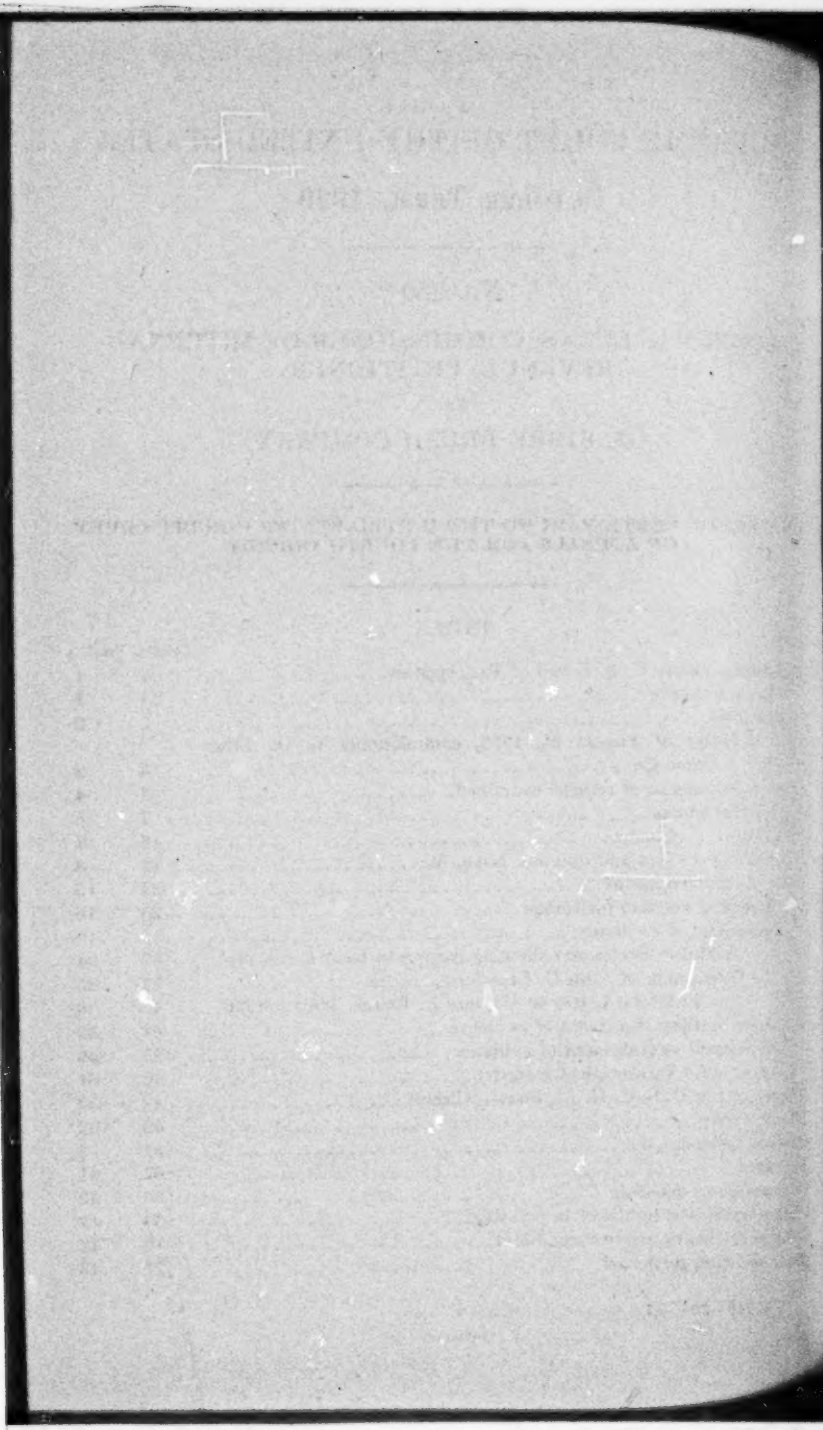
vs.

OX FIBRE BRUSH COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

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1 Before United States Board of Tax Appeals

Docket 8153

OX FIBRE BRUSH COMPANY, FREDERICK, MD., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

For the taxpayer, H. B. Sutter, Esq.; for the Comm'r, M. N. Fisher, Esq.

Docket Entries

1925		
Oct.	16.	Petition received & filed.
"	23.	Copy of petition served on solicitor.
"	23.	Notification of receipt mailed taxpayer.
Nov.	10.	Answer filed by solicitor.
"	14.	Copy of answer served on taxpayer. Assigned general calendar.
1926		
Nov.	9.	Hearing date set for 1-20-27.
1927		
Jan.	20.	Hearing had before Mr. Love on merits, Briefs due 2-24-27.
"	28.	Transcript of hearing 1-20-27 filed.
Feb.	23.	Brief filed by taxpayer.
"	24.	" " " G. C.
Oct.	1.	Finding of fact & opinion rendered (Love). Judgment will be entered for the Comm'r. Both sides notified.
"	1.	Order of redetermination signed & filed. Both sides notified.
"	28.	Motion for review & reconsideration filed by taxpayer.
Nov.	14.	Ordered above motion denied. Both sides notified.

2 1928

Mar.	10.	Supersedeas bond for $48,183.20 approved & ordered filed.
"	27.	Agreement for review by U. S. Cir. Ct. of Ap., 4th Circuit, filed.
"	27.	Petition for review with assignments of error filed by taxpayer.
"	27.	Proof of service filed.
May	4.	Amended petition for review filed by taxpayer.
"	4.	Proof of service for filing petition for review filed by taxpayer.
"	12.	Agreed praecipe filed.
"	12.	" statement of evidence lodged.
"	14.	" " " " approved & ordered filed.

Now, May 15, 1928, the foregoing docket entries certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

Before United States Board of Tax Appeals

Docket No. 8153

Appeal of Ox Fibre Brush Company, Frederick, Maryland.

Petition

Filed Oct. 16, 1925

The above-named taxpayer hereby appeals from the determination of the Commissioner of Internal Revenue set forth in his deficiency letter (IT:CR:E–HE–6OD), dated August 25, 1925, and as the basis of its appeal sets forth the following:

1. The taxpayer is a West Virginia corporation with its principal office at Frederick, Maryland.

2. The deficiency letter (a copy of which is attached) was mailed to the taxpayer on August 25, 1925.

3 3. The taxes in controversy are income and profits taxes for the calendar year 1920 and are more than $10,000.

4. The determination of tax contained in said deficiency letter is based upon the following errors:

(a) The Commissioner of Internal Revenue erred in failing to allow as a deduction from gross income in computing taxable net income for the calendar year 1920, $24,000 of compensation accrued during that year to J. K. Robinson, jr., president, and $24,000 of compensation accrued during that year to A. McEwen, treasurer.

(b) The Commissioner of Internal Revenue erred in disallowing as a deduction from gross income in computing taxable net income for the year 1920, $24,000 accrued during that year as compensation to J. K. Robinson, jr., president, for services rendered, and $24,000 accrued during that year as compensation to A. McEwen, treasurer, for services rendered.

5. The facts upon which the taxpayer relies as the basis of its appeal are as follows:

During 1920, there was accrued and paid on the books of this taxpayer compensation to J. K. Robinson, jr., president, for services rendered in the amount of $36,000. The Commissioner of Internal Revenue disallowed as a deduction for 1920, $24,000 of the compensation accrued and paid to J. K. Robinson, jr., president, for his services. There was also accrued and paid on the books of the corporation for 1920, $39,000 to A. McEwen, treasurer, as compensation for services rendered by him. The Commissioner of Internal Revenue disallowed as a deduction for 1920, $24,000 of the compensation accrued and paid to A. McEwen for his services.

J. K. Robinson, jr., and A. McEwen, were, during 1920, the active managing officers of the company. They gave their time and attention to their duties as president and treasurer, respectively, of the company. The compensation paid these officers in 1920
4 for their services were reasonable, and was based upon the value of the services rendered to the corporation.

6. The taxpayer, in support of its appeal, relies upon the following propositions of law:

Section 234 (a) (1) of the Revenue Act of 1918 provides, in part, as follows:

"That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

"All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered * * *."

Wherefore, taxpayer respectfully prays that this board may hear and determine its appeal.

ALBERT L. HOPKINS,
HARRY B. SUTTER,
RICHARD S. DOYLE,
Counsel for Taxpayer,
110 South Dearborn Street, Chicago, Illinois.

Duly sworn to by J. K. Robinson, jr.; jurat omitted in printing.

5 TREASURY DEPARTMENT, WASHINGTON,

OFFICE OF COMMISSIONER OF INTERNAL REVENUE

Aug. 25, 1925.

IT:CR:E
HE:6OD

OX FIBRE BRUSH COMPANY,
Frederick, Maryland.

Sirs: A reexamination of your income-tax returns and additional data submitted at conference for the calendar year 1920 and 1921 discloses an additional tax due for 1920 amounting to $24,091.60 and an overassessment for the year 1921 amounting to $2,299.20, as shown in the attached statement and accompanying schedules.

In accordance with the provisions of section 274 of the revenue act of 1924, you are allowed 60 days from the date of mailing of this letter within which to file an appeal to the United States Board of Tax Appeals contesting in whole or in part the correctness of this determination.

Where a taxpayer has been given an opportunity to appeal to the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made, or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement respect of any part of the deficiency will be entertained.

If you acquiesce in this determination and do not desire to file an appeal, you are requested to sign the inclosed agreement consenting to the assessment of the deficiency and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:CR:E-HE-60D. In the event that you acquiesce in
6 a part of the determination, the agreement should be executed with respect to the items agreed to.

Respectfully,

D. H. BLAIR,
Commissioner,
By J. G. BRIGHT,
Deputy Commissioner.

Inclosures:
Statements
Agreement—Form A.
Schedule 1 to 15, incl.

IT:CR:E

STATEMENT OF RETURNS EXAMINED AND RESULTING TAX LIABILITY

Returns examined

Ox Fibre Company, Frederick, Maryland	1920	1120 cons.
	1921	1120 cons.
American Fibre Company, Jacksonville, Fla.	1920	Included
	1921	above.
Frederick Mfg. Company, Frederick, Md.	1920	Included
	1921	above.

Tax liability

Ox Fibre Brush Company:	Additional tax	Overassessed
Year 1920	$24,091.69	
1921	----------	$2,299.29
Net additional tax	$21,792.40	---------

The adjustments producing the above tax liability are contained in the attached Schedules 1 to 15, inclusive, based upon a revenue agent's report dated October 31, 1923, brief dated June 16,
7 1925, and supplement thereto dated July 16, 1925, and conference held in Washington, on July 9, 1925.

A certificate of overassessment for the amount shown above will be issued through the office of the Collector of Internal Revenue for your district and will be applied by that official in accordance with the provisions of section 281 (a) of the revenue act of 1924.

The right of appeal as set forth herein applies only to the year 1920, in which there is a deficiency in tax as defined by section 273 of the revenue act of 1924.

Year ended December 31, 1920

Schedule 1—Net income

Ox Fibre Brush Company:

Net income as disclosed by bureau May 25, 1925	$210,161.81
As corrected	206,753.67
Net deductions—Additional depreciation allowed	$3,408.14

Schedule 2—Explanation of items changed

(a) In accordance with conference decision, the depreciation rate on machinery, etc., is increased to 11-1/9% same as allowed for 1918 and 1919.

Cost, 1/1/1920	$297,093.77	
12/31/1920	316,372.53	
	$613,466.30	
Average, 306,733.15 @ 11-1/9%		$34,081.46
Allowed in bureau letter May 28, 1925		30,673.32
Additional depreciation allowed		$3,408.14

Schedule 3—Net income

American Fibre Company:

Net loss as disclosed by bureau letter May 25, 1925	$30,478.30
As corrected	No change.

Schedule 4—Consolidated net income 1920

Net income as corrected:		
Ox Fibre Brush Company	$206,753.67	
Net loss as corrected:		
American Fibre Company	30,478.30	
Total		$176,275.37

Schedule 5—Consolidated invested capital 1920

As shown in bureau letter May 25, 1925	$751,088.31
As corrected	No change.

Schedule 6—Excess-profits credit

No change	$68,083.06

Schedule 7—Computation of total tax 1920

Excess-profits tax	Income	Tax
Net income for taxable year (Schedule 4)	$176,275.37	
Less excess-profits credit	63,083.06	
Balance	$113,192.31	
Taxable at 20%, 150,207.66 less 63,083.06	87,124.60	$17,424.92
Taxable at 40%	26,067.71	10,427.08
		27,852.00

Income tax:			
Net income for taxable year		$176,275.37	
Less: Interest on obligations of United States not exempt	$332.50		
Excess profits tax	27,852.00		
Exemption	2,000.00		
		30,184.50	
Taxable at 10%		$146,090.87	$14,609.09
Total, excess-profits, and income taxes			$42,461.09
Previously assessed #402123			18,369.49
Additional tax to be assessed			$24,091.60

Schedule 8—Net income

Ox Fibre Brush Company:	
Net income as disclosed by bureau letter May 25, 1925	$128,690.72
As corrected	125,018.25
Net deductions—Additional depreciation allowed	$3,672.47

10 *Schedule 9—Explanation of items changed*

(a) See Schedule 2, computed for 1921 as follows:	
Cost machinery, Dec. 31, 1920	$316,372.53
Dec. 31, 1921	344,669.24
	661,041.77
Average, $330,520.89 @ 11-1/9%	$36,724.57
Allowed in bureau letter May 25, 1925	33,052.10
Additional depreciation allowed	$3,672.47

Schedule 10—Net income

American Fibre Company:	
Net loss as disclosed by bureau letter May 25, 1925	$5,128.45
As corrected	No change.

Schedule 11—Consolidated net income 1921

Net income as corrected, Ox Fibre Brush Company	$125,018.25
Net losses as corrected, American Fibre Company	5,128.45
Aggregate net income	$119,889.80

11 *Schedule 12—Consolidated invested capital 1921*

As shown in bureau letter dated May 25, 1925			$736,736.87
As corrected			733,991.33
Net decrease as explained below			$2,745.54
Increases:			
(a) Adjusted prorated 1920 tax		$662.60	
Decreases:			
(b) Additional depreciation allowed 1920		3,408.14	
Net decrease as above			$2,745.54

Schedule 13—Explanation of items changed

(a) The adjusted 1920 tax as shown in Schedule 7 of this letter is prorated out of invested capital, as follows:

1920 tax prorated in letter dated May 25, 1925	$18,606.59
Corrected 1920 tax $42,461.09 prorated (.4226)	17,943.99
Excess is restored	$662.60

(b) Additional allowance for depreciation is a reduction of surplus as at December 13, 1920.

12 *Schedule 14—Computation of excess profits credit*

Consolidated net income taxable year (Schedule 11)	$119,889.80
Consolidated invested capital taxable year (Schedule 12)	$733,991.33
Excess profits credit:	
8% of invested capital for taxable year	$58,719.31
Exemption	3,000.00
Excess-profits credit	$61,719.31

Schedule 15—Computation of total tax 1921

Excess-profits tax	Income		Tax
Net income for taxable year	$119,889.80		
Less excess-profits credit	61,719.31		
Balance	$58,170.49		
Taxable at 20%			$11,634.10
Income tax:			
Net income for taxable year	$119,889.80		
Less:			
Interest on obligations of United States not exempt	$332.50		
Excess-profits tax	11,634.10	11,966.60	
Taxable at 10%	$107,923.20		10,792.32
13 Total, excess-profits and income taxes			$22,426.42
Previously assessed $400,720			24,725.62
Overassessed			$2,299.20

Now, May 15, 1928, the foregoing petition certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

Before United States Board of Tax Appeals

Docket No. 8153

Appeal of Ox Fibre Brush Company, Frederick, Maryland

Answer

Filed Nov. 10, 1925

The Commissioner of Internal Revenue, by his attorney, A. W. Gregg, Solicitor of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

(1) Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

(2) Denies that any error was made in the determination of the deficiency in tax set out in the letter of August 25, 1925.

(3) Admits that the commissioner disallowed $24,000 of the salary to J. K. Robinson, jr., and $24,000 of the salary to A. McEwen in the year 1920.

(4) Admits that in that year J. K. Robinson, jr., and A. McEwen were respectively president and treasurer of the taxpayer corporation and that they performed the duties of those offices.

(5) Denies that the compensation paid to the aforesaid officers in 1920 is reasonable and based upon the value of the services rendered to the taxpayer.

(6) Denies, generally, and specifically, each and every allegation in the taxpayer's petition contained not hereinbefore admitted, qualified, or denied.

Under the provisions of section 234 (a) (1) of the revenue act of 1918 the deduction on account of salaries paid to officers of a corporation is limited to a reasonable allowance for the services actually rendered.

Wherefore it is prayed that the taxpayer's appeal be denied.

A. W. GREGG,
Solicitor of Internal Revenue,
Attorney for Commissioner of Internal Revenue.

Of counsel:

M. N. FISHER,
Special Attorney, Bureau of Internal Revenue.

[Certificate to foregoing paper omitted in printing.]

Before United States Board of Tax Appeals

OX FIBRE BRUSH COMPANY, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, respondent	Docket No. 8153. Promulgated October 1, 1927.

Findings of fact and opinion

Additional compensation in the amount of $48,000 voted and accrued by the petitioner in May, 1920, to its president and treasurer was in excess of reasonable compensation for personal services actually rendered in that year.

Harry B. Sutter, Esq., for the petitioner; W. N. Fisher, Esq., for the respondent.

This proceeding is for the redetermination of a deficiency in income and profits taxes for the calendar year 1920 in the amount of $24,091.60. The entire amount of the deficiency is not in dispute but only so much thereof as arises from the disallowance by the commissioner of the additional salaries paid by the petitioner to its

president and treasurer in that year and deducted from gross income as ordinary and necessary business expenses.

Findings of fact

The petitioner is a corporation organized under the laws of the State of West Virginia. It was, during the year 1920 and for many years prior thereto, engaged in the manufacture of brushes. Its factory is located at Frederick, Maryland. Its executive offices and principal sales headquarters are located in New York City. The petitioner also has branch sales offices at St. Louis, Cincinnati, Philadelphia, and Boston.

J. K. Robinson, jr., was petitioner's president during the year 1920 and had been its president since 1905 or 1906. Alfred McEwen joined the petitioner in 1907, became its treasurer at that time and continued in that office through the year 1920. Both the president and treasurer of the petitioner from 1907 until and including 1920, devoted their entire time to the promotion of its interests. During the year 1920 and in years prior and subsequent thereto they lived in or near New York City and performed their duties primarily at the executive offices located there.

In the year 1907, when Robinson and McEwen assumed control of the petitioner, the factory was in a chaotic state and was operating at a loss. In a large measure due to their efforts, the petitioner progressed to a foremost position in the brush trade and was frequently importuned by competitors to buy them out or combine with them.

16 Prior to the year 1917 a technical expert managed the petitioner's factory, for which he received $10,000 per annum. In the year 1917 Robinson and McEwen took over the general management of the factory. The services of the technical expert were dispensed with, and in his place a factory superintendent was employed at a much lower salary to supervise routine work. In addition to their regular executive duties the president and treasurer handled all large purchases, directed all sales, directed the hiring of personnel, and directed the policies of the petitioner and lines of factory development. These services were rendered from 1917 until and including 1920.

During the early part of the year 1920 the petitioner was negotiating with two large brush-manufacturing concerns relative to purchasing those concerns. These negotiations were dropped in April, 1920, but while pending they necessitated on the part of Robinson and McEwen considerable traveling, visiting of plants, and work pertaining to the possible reorganization thereof. The plants, the purchase of which was under consideration, subsequently failed.

In addition to the annual salaries of $12,000 and $15,000 paid, respectively, to the president and treasurer, the board of directors at a meeting held on May 6, 1920, pursuant to notice to all directors, unanimously voted to pay each of these officers additional compensation of $24,000. The minutes of the meeting, so far as pertinent here, are as follows:

* * * * * * *

"This meeting having been specially called for the purpose of considering and acting upon the proposal for a grant of additional compensation to Mr. J. K. Robinson, jr., and to Mr. Alfred McEwen, for their past services to the company, * * *

"Resolved that this board hereby authorize and direct the payment of the sum of twenty-four thousand ($24,000) dollars to Mr. J. K. Robinson, jr., as extra compensation for his past services to this company, as an officer thereof and in any other capacity, the same to be paid when, in the discretion of the officers, funds of this corporation for this purpose are available.

17 "Resolved that this Board authorizes and directs the payment of the sum of twenty-four thousand ($24,000) dollars, to Mr. Alfred McEwen as extra compensation for his past services to this company as an officer thereof and in any other capacity, the same to be paid when in the discretion of the officers, funds of this corporation for this purpose are available."

* * * * * * *

The petitioner's books were kept on the accrual basis, and in May, 1920, proper entry was made therein by crediting the accounts of the president and treasurer with the additional compensation voted and charging the expense accounts therewith.

The total compensation of $56,000 and $39,000 for the president and the treasurer, respectively, accrued and paid in the year 1920, was voted by the board of directors, having regard for the past services rendered by these officers, for the fact that they had to live in New York City, and as a reward for good efforts given to the business as demonstrated by the results accomplished.

The directors of the petitioner were J. K. Robinson, jr., Alfred McEwen, John G. Crawford, a former vice president who was originally employed and brought into the business by McEwen, and Emory L. Coblentz, a banker of Frederick, Maryland, with whom the petitioner transacted a large part of its banking business. J. K. Robinson, jr., and Alfred McEwen and their families owned approximately 36 per cent of the stock of the petitioner. Of the remaining outstanding stock of the petitioner a portion was owned by employees and a portion by Robinson's mother and sister.

Officers' salaries, gross sales, amounts carried to surplus after deducting officers' salaries and other expenses, dividends declared and paid, and the amount of capital stock outstanding for the years 1908 to 1914, inclusive, and 1918 to 1922, inclusive, were as follows:

	Officers' salaries	Gross sales	Net earnings—Amount carried to surplus	Dividends declared and paid	Outstanding capital stock
	$6,000.00	Not shown.	$3,972.44	None.	$300,000.00
	6,000.00	$374,236.66	41,985.36	None.	275,000.00
	9,999.00	467,943.50	68,009.99	$8,686.50	286,600.00
	9,999.00	521,650.78	21,611.75	4,500.00	298,600.00
	9,999.00	596,910.57	52,013.74	4,500.00	300,000.00
	10,999.00	612,087.57	49,810.44	13,387.50	297,500.00
	16,000.00	596,856.83	18,591.95	4,462.50	297,500.00
data furnished for 1918 to 1917.)					
	25,384.64	1,068,641.46	152,679.16	56,576.00	465,400.00
	27,000.00	1,193,742.39	211,130.52	133,579.50	474,700.00
	75,000.00	1,273,474.72	152,753.67	(125,275.00 800,000.00	Cash. Stock.
	27,000.00	980,376.56	128,745.07	94,388.00	899,000.00
	33,000.00	1,342,834.03	255,762.16	170,860.00	900,000.00

The regular, additional, and total salaries paid or accrued to the titioner's president and treasurer in the year 1920 were not in oportion to the number of shares of stock held by them.

In computing the petitioner's taxable income for the year 1920 e commissioner disallowed as a deduction the additional compensa- n of $48,000 voted and accrued in 1920 to the president and asurer under the circumstances above set forth.

Opinion

Love: The sole issue in this proceeding is whether the additional npensation in the amount of $48,000 voted and accrued in the year 0, pursuant to the action taken by the board of directors on May 1920, to the petitioner's president and treasurer may be deducted m gross income for that year.

It is necessary, first, for us to determine the status of the additional npensation in question. Was it voted as and for salaries for 1920, hough measured by services rendered prior to that year, or was it ed and accrued in 1920 as and for salaries for services performed prior years? If the additional compensation comes within the ter classification, then, in our opinion, it may not be deducted the year 1920. Appeal of Vaughan & Barnes, Inc., 6 B. T. A. 1279.

The resolution of May 6, 1920, is ambiguous and might be susceptible to either interpretation. The resolution, in part, s:

This meeting having been called for the purpose of considering l acting upon the proposal for a grant of additional compensation Mr. J. K. Robinson, jr., and Mr. Alfred McEwen for their past vices to the company * * *"

t the hearing the history of the petitioner was opened up and dence was introduced with respect to the action taken by the rd of directors and of their intention in connection therewith.

We have held in the Appeal of Union Dry Goods Co., 1 B. T. A. 833, that the minute as written is not conclusive as to the year for which additional compensation was authorized. From all of the evidence adduced, we are of the opinion that the additional compensation voted and accrued in May, 1920, was intended to be as and for, and was as and for salaries for the year 1920. The motivating or impelling influence, however, in determining the amount to be paid as additional compensation for the year 1920 was the services rendered by the officers in question prior to that year. In other words, the additional compensation for 1920 was based upon efficiency and ability of the officers as demonstrated by past performances and results achieved over the preceding period of years.

Section 234 (a) (1) which provides for the deduction of salaries reads, in part, as follows:

"(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered * * *."

It follows, therefore, that if the regular annual salaries of the petitioner's president and treasurer plus the additional salaries of $48,000 constituted reasonable compensation for services actually rendered by those officers in 1920, the deduction on account thereof is properly allowable. The petitioner urges that the total compensation for 1920 was reasonable in amount for services actually rendered in that year by the officers in question, and the respondent insists that it was unreasonable.

In support of its contention that such amount was reasonable compensation for 1920, the petitioner takes the position that the action of the board of directors of a corporation in authorizing salaries for a given year raises a presumption that the amount voted is reasonable and complies with the statute until the contrary be proven. In other words, the petitioner insists that the burden of proof is on the respondent to show that the salaries for 1920 were unreasonable. We are unable to agree with the petitioner in this respect.

Our attention is called to the case of United States v. Philadelphia Knitting Mills Co., 273 Fed. 657, as supporting the petitioner's position that the compensation in dispute is presumed to be reasonable until the presumption is overcome. In that case the court was construing the corporation excise tax act of 1909, which provided for a tax at a named rate upon the net income of a corporation to be ascertained by deducting from its gross income "all ordinary and necessary expenses." The statute did not specifically make salary an allowable deduction, though it was so construed by the Bureau of Internal Revenue when the salary is a "reasonable and fair compensation for services rendered regardless of the amount of stock such officer may hold." The court in holding that, under the statute, the Government may not determine whether salary paid corporation

officers is a reasonable and fair compensation, but may determine whether it is salary that is paid or whether it constitutes profits diverted to a stockholding officer under the guise of salary, stated:

"Confining our inquiry to the statute, it appears that the basis on which a salary may be allowed as a valid deduction is that it was in fact an 'ordinary and necessary expense (of the corporation) actually paid * * * in the maintenance and operation of its business.' To be a necessary expense it must have been paid for services actually rendered. Jacobs & Davies, Inc., Anderson, 288 Fed. 505, 506, 143 C. C. A. 87. Whether services were rendered and whether also they were commensurate with the salary paid are
21 matters of judgment and discretion reposed by general law in the board of directors of the corporation. As the board of directors is charged with the duty and clothed with the discretion of fixing salaries of the corporation's officers, the Government has no right (until expressly granted by statute) to inquire into and determine whether the amounts thereof are proper—that is, whether they are too much or too little. But while the amount of salary fixed by a board of directors is presumptively valid, it is not conclusively so, because the Government may inquire whether the amount paid is salary or something else. Admittedly the Government has a right to collect taxes on net income of a corporation based on profits after all ordinary and necessary expenses, including salaries, are paid. It has a right, therefore, to attack the action of a board of directors and show by evidence, not that a given salary is too much, but that, in the circumstances the whole or some part of it is not salary at all but is profits diverted to a stockholding officer under the guise of salary and as such is subject to taxation * * *. The question of fact here was whether the money paid was all salary or part profits. *The presumption arising from the action of the board of directors was that it was all salary.* In order to overcome the presumption the burden was on the Government to produce evidence, not necessarily conclusive, but sufficient to raise a valid inference that some definite part of the compensation was not salary but profits. (Emphasis supplied.)

It is apparent from the foregoing statement that the court was not considering the reasonableness of the compensation sought to be deducted. The only question before it was whether the amount sought to be deducted was in fact salary, and with respect to the amount fixed as salaries the court stated that there was a presumption that it was in fact all salary. That is simply another way of saying that the acts of the board of directors of a corporation are presumed to be regular and valid.

The revenue act of 1918 differs from the corporation excise tax act of 1909 with respect to the deduction of salaries, in that section
22 234 (a) (1) supra specifically provides for a deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered." Pursuant to this pro-

vision, as stated in the case of William S. Gray & Company v. United States, decided by the Court of Claims June 6, 1927, "it is undoubtedly the right, as well as the duty, of the Commissioner of Internal Revenue under the provisions of the 1918 revenue act to determine the reasonableness of the salaries of which a deduction is asked by the taxpayer, as well as to decide whether or not the salaries are ordinary and necessary expenses in the maintenance and operation of the business."

In the Appeal of Gustafson Manufacturing Company, 1 B. T. A. 508, we stated:

"Counsel for taxpayer contends that the directors of the corporation are the sole judges as to what constitutes reasonable compensation, and that since they determined upon $20,000 as a salary to be paid the president and general manager for 1918 the commissioner has no authority to reduce the amount notwithstanding the fact that the salary was based upon earnings or was a distribution of profits of the corporation in the form of compensation. This contention, of course, can not be sustained."

* * * * * * *

"Under the provision of this section (234 (a) (1) supra) the commissioner not only has the authority but it is his duty to determine under all of the facts obtainable the reasonableness or unreasonableness of deductions by a corporate taxpayer of compensation paid. The commissioner, upon the evidence before him, determined that a deduction of $16,000 for compensation for the services rendered taxpayer by its president and general manager during the year 1918 was reasonable. The evidence before us does not justify a deduction for compensation of an amount in excess of that determined by the commissioner."

In The W. K. Henderson Iron Works & Supply Co. v. Commissioner of Internal Revenue, 6 B. T. A. 92, we stated in part:

23 "* * * It may be that such additional salaries paid in 1919, when added to the regular salaries paid in 1919, constitute a reasonable compensation for personal services actually rendered in that year, but we have no evidence before us concerning the salaries paid, service performed, or the volume or character of business done during the year 1919, and we are, accordingly, without the necessary facts to determine the issue for that year."

We conclude, therefore, that the action taken by the board of directors in voting the total compensation to the officers in question for 1920 does not raise a presumption that the amount voted was in fact reasonable for services actually rendered, thereby complying with the terms of the statute. The commissioner having determined that the additional compensation voted in May, 1920, was unreasonable for services actually rendered in that year, it becomes necessary for the petitioner, if the deduction is to be allowed, to show that he erred in his determination. We therefore, must be guided

in our determination as to the reasonableness of the compensation in dispute by the evidence adduced in this proceeding.

It will be noted from the table set out in the findings of fact that the petitioner was prosperous in years prior to 1920. It will also be noted that the compensation for 1920 to the officers in question was more than two times the amount received in any other year. There is nothing in the record to indicate that additional salaries might be expected or would be granted in the future, and there is nothing to indicate that the duties performed were materially different from those performed in preceding or succeeding years. It is not intimated that the compensation received prior to and subsequent to 1920 was inadequate. Under these circumstances we are of the opinion that the salaries paid by the petitioner to its officers in years prior to and subsequent to 1920 is the best evidence of their reasonableness and their value to the petitioner in that year. The deliberate, bona fide action of the board of directors over a period of years is persuasive in such matters.

It may be conceded that the officers in question were
24 efficient and brought prosperity to the petitioner and that the additional compensation was a merited recognition on the part of the board of directors of the valuable services rendered prior to 1920, but all of the evidence tends to the conclusion that the extra compensation for 1920 was in excess of reasonable compensation for services performed in that year.

We approve, therefore, the respondent's determination in disallowing as a deduction for the year 1920 the additional salaries in the amount of $48,000.

Judgment will be entered for the respondent.

Considered by Smith and Littleton.

[Certificate to foregoing paper omitted in printing.]

Before United States Board of Tax Appeals, Washington

Ox Fibre Brush Company, petitioner vs. Commissioner of Internal Revenue, respondent	Docket No. 8183

Order of redetermination

Pursuant to the Board's findings of fact and opinion, promulgated October 1, 1927, it is

Ordered and decided that, upon redetermination, there is a deficiency for the year 1920 in the amount of $24,091.60.

(Signed) William D. Love,
Member United States Board of Tax Appeals.

Dated Washington, D. C., October 1, 1927.

25 [Certificate to foregoing paper omitted in printing.]

Before United States Board of Tax Appeals

OX FIBRE BRUSH COMPANY, PETITIONER
vs.
DAVID H. BLAIR, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT
Docket No. 8153

Amended petition for review

Filed May 4, 1928

To the honorable the Judges of the United States Circuit Court of Appeals for the Fourth Circuit:

Your petitioner, Ox Fibre Brush Company, respectfully shows:

I

Jurisdiction for review

This is a proceeding for review by the United States Circuit Court of Appeals for the Fourth Circuit of a decision of the United States Board of Tax Appeals, entered on the first day of October, 1927, and redetermining a deficiency in income and excess profits taxes for the calendar year 1920 against your petitioner in the amount of $24,091.60.

II

Your petitioner is a corporation organized under the laws of the State of West Virginia, with its factory located at Frederick, Maryland, and its executive offices and principal sales headquarters in New York City.

31 Your petitioner made its income and excess-profits tax return for the year 1920 to the collector of internal revenue at Baltimore, Maryland.

III

Nature of controversy

The nature of the controversy before the United States Board of Tax Appeals concerned the propriety of the disallowance as a deduction, in the determination of the taxable net income, of certain compensation voted and paid by your petitioner to certain of its officers in 1920, as follows:

During 1920 your petitioner voted and paid $39,000.00 as compensation for the services of its president, and during the same year voted and paid $36,000.00 to its treasurer as compensation for his

services. On its income and profits tax return for the calendar year 1920 your petitioner deducted the total of these payments, $75,000.00, in computing taxable net income. The Commissioner of Internal Revenue disallowed as a deduction to your petitioner $24,000.00 out of the salary paid to the president and $24,000.00 out of the salary paid to the treasurer, total $48,000.00, and fixed a salary of $15,000.00 for the president and $12,000.00 for the treasurer as the reasonable compensation for the services of these officers.

IV

Assignments of error

The Board of Tax Appeals approved the aforementioned action of the Commission of Internal Revenue, and in so doing submitted the following errors, upon which the petitioner relies as the basis of this proceeding:

1. The United States Board of Tax Appeals erred in failing to find that a salary of $39,000.00 for the president of your petitioner and a salary of $36,000.00 for the treasurer of your petitioner, voted and paid in 1920 as compensation for services, were reasonable and deductible in computing the taxable net income of your petitioner for the calendar year 1920, though such finding was amply supported by evidence.

2. The United States Board of Tax Appeals erred in finding that a salary of $15,000.00 for the president of your petitioner and a salary of $12,000.00 for the treasurer of your petitioner were reasonable compensation for the services of these officers rendered to your petitioner for the calendar year 1920, there being no evidence in the record to support any such finding.

3. The United States Board of Tax Appeals erred in excluding from evidence on behalf of petitioner a statement of loans by banks, from 1908 to 1921, inclusive, personally guaranteed by the president and treasurer of petitioner.

4. The United States Board of Tax Appeals erred in failing to find upon the evidence that the duties performed by the president and treasurer, respectively, of your petitioner during the calendar year 1920 were materially different from the services performed by these officers in the preceding and succeeding years, and that, consequently, evidence of compensation voted and paid to these officers for those years was immaterial and irrelevant and should be given no weight whatever.

5. The United States Board of Tax Appeals erred in finding that the duties performed by the president and treasurer, respectively, of your petitioner during the calendar year 1920 were not materially different from the services performed by these officers in the preceding and succeeding years, there being no evidence to support such finding.

6. The United States Board of Tax Appeals erred in failing to find that the compensation paid the president and treasurer, respectively, of your petitioner for services rendered prior and subsequent to 1920 was inadequate, there being ample evidence to support such a finding.

28 7. The United States Board of Tax Appeals erred in excluding evidence offered by petitioner tending to show that there was discussion in prior years relevant and relating to the inadequacy of compensation then paid to the president and treasurer.

8. The United States Board of Tax Appeals erred in failing to find that the compensation paid the president and treasurer, respectively, of your petitioner prior to 1920 was inadequate, there being ample evidence to support such a finding.

9. The United States Board of Tax Appeals erred in giving any weight whatever to evidence of compensation paid in the years preceding and succeeding the year 1920 without affirmative evidence that the conditions existing in those years were the same, and that the compensation paid was inadequate, there being ample evidence that conditions were different and the compensation paid was inadequate.

10. The United States Board of Tax Appeals erred in holding that the burden of proof was on your petitioner to establish that the compensation voted and paid its president and treasurer in 1920 was reasonable merely because of the contrary determination by the Commissioner of Internal Revenue.

11. The United States Board of Tax Appeals erred in failing to hold that the formal action taken by the board of directors of your petitioner in voting compensation for services to its president and treasurer for the year 1920 raised a presumption in fact and in law that the amounts, respectively, voted were reasonable for the services rendered by such officers.

12. The United States Board of Tax Appeals erred in holding that the formal action taken by the board of directors of your petitioner in voting compensation for services to its president and treasurer for the year 1920 did not raise a presumption that the amounts, respectively, voted were reasonable for the services rendered by such officers.

13. The United States Board of Tax Appeals erred in its conclusions of law.

29 14. The determination of ultimate facts by the United States Board of Tax Appeals is not reasonably supported by facts and is contrary to the weight of the evidence.

Wherefore your petitioner prays that this court may review the determination of the Board of Tax Appeals in this cause, reverse the decision of the board, and direct said board to allow a deduction of $75,000.00 as compensation for services of your petitioner's president and treasurer in 1920 in computing your petitioner's tax-

the net income for that year, and/or other and further relief as may to this court appear proper in the premises.

RICHARD S. DOYLE,
CHARLES D. HAMEL,
HARRY B. SUTTER,
JOHN ENRIETTO,
Attorneys for Petitioner,
906 Southern Building, Washington, D. C.

[Duly sworn to by Richard S. Doyle; jurat omitted in printing.]

[Certificate to foregoing paper omitted in printing.]

Before United States Board of Tax Appeals

OX FIBRE BRUSH COMPANY, PETITIONER v. DAVID H. BLAIR, COMMISSIONER OF INTERNAL REVENUE, respondent	Docket No. 8153

Statement of evidence

Lodged May 12, 1928; filed May 14, 1928

The above-entitled cause came on for hearing before the Honorable William D. Love, member of the United States Board of Tax Appeals, on the 20th day of January, 1927, there being present the petitioner, by its counsel, Harry B. Sutter, and the respondent, by his counsel, M. N. Fisher.

Whereupon, the petitioner, to maintain the issues on its behalf, introduced the testimony of Emory L. Coblentz, Frank M. Dertzbaugh, John G. Crawford, and Alfred McEwen, together with certain exhibits as follows:

Ox Fibre Brush Company is a corporation organized under the laws of the State of West Virginia. The executive offices, whence emanated the policies of management of the company and where quite a sales headquarters was maintained, were located in New York. At Frederick, Maryland, administrative offices only, such as those necessary to conduct the factory and clerical equipment were maintained. At Frederick all the articles sold by the company were manufactured.

Alfred McEwen is president and treasurer of the Ox Fibre Brush Company and resides at Tarrytown, New York. He has been president for about a year, and entered the empl'y of Ox Fibre Brush Company in November, 1907. Prior thereto he had been employed by the Western Electric Company. Beginning with the year 1888, he went through their shops from the machinists' trade up to installing electrical machinery. The electrical

science was just developing with the company at that time, and there was very little in the way of electrical appliances, except the electrical bell and burglar alarms. Mr. McEwen went through their factory and its different branches, and when he left there in 1907, after having been there about 20 years, he was in charge of the machinery sales of the Chicago department. He left the Western Electric Company to join the Ox Fibre Brush Company in 1907.

Ox Fibre Brush Company was started and owned by Mr. Alfred McEwen's father-in-law, J. K. Robinson, sr. When Mr. McEwen married, Mr. Robinson, sr., suggested that he go to Frederick and see what he could do with the Ox Fibre Brush Company, which was a constant nuisance and a source of expense to Mr. Robinson. At that time, Mr. Robinson's son, J. K. Robinson, jr., was president of the company. He had preceded Mr. McEwen to Frederick by about two years. He was a much younger man than Mr. McEwen, had never had any factory experience, and had found a problem that he could not exactly cope with. His father concluded he needed some help, so he called on Mr. McEwen to help him, and when Mr. McEwen went there the two men joined forces in putting the plant into shape. Mr. McEwen did not become treasurer until much later.

The period was the formative period in the brush business in this country. At that time the largest manufacturers of brushes in the country were those who manufactured them on contract prison labor and the brushes were made in the various prisons of the country, referring now to the type of brush the Ox Fibre Brush Company makes—i. e., the common scrub brush and coarse brushes. Manufacturing could not continue under the conditions existing at that time. A large quantity of the brushes made were made in homes, the manufacture of a brush being a very simple hand operation. The trade was handed down from father to son, and they would make these brushes in the basements of their
32 homes and go out from house to house and sell them. There was very little modern business carried on in the brush industry. Altogether it was an unsatisfactory business, and no profit was made in the industry, and there was very little attempt made to build it up into a high-grade business at that time.

In 1907 the Ox Fibre Brush Company consisted of a fairly small factory that had been run in a haphazard manner and very badly managed, with no system of accounting. They had a bookkeeper who kept the cash balance by taking change from his pocket and putting change back in the till whenever he wanted to even things up. The natives of the town used to go into the factory, pick out a brush that they wanted, take it out, and it was a constant sink hole. So by that time Mr. Robinson had somewhere around $200,000 in cash put into it and nothing had ever been taken out, and there was no chance of taking anything out. The company had experimented with a female sales organization. They employed many

women to go around to the retail trade and solicit orders, which in turn were handed on to the jobber, and in turn they brought them to the factory. It left a bad odor throughout the country that took years to get rid of. The company had one office in Chicago, where it did a fair jobbing business.

Ox Fibre Brush Company never employed prison labor, and it was not in a position to compete with concerns using contract prison labor in the manufacture of brushes.

After Mr. McEwen had been in Frederick for a few months he discovered that the shop was not what it should be in many ways, and persuaded Mr. Robinson that, although they would have to pay a higher salary than they were giving at the time for a man, in order to get a high-grade shop man who could take that factory and place it on a proper manufacturing basis and keep it in the line of development to enable them to go ahead with the sale of brushes and develop a sales organization at the same time, to handle the increased product the shop might turn out, they should do so. Mr. Robinson agreed to that, and the result was that Mr. McEwen referred to his old friend Crawford, who had been associated with him for a great many years. Knowing his ability, Mr. McEwen wired him and asked him if he would consider such a proposition.

33 The officers employed a higher grade of salesmen and opened five branch offices in different parts of the country in which these salesmen were located to cover the adjoining territory, at St. Louis, Cincinnati, Philadelphia, New York and Boston. The officers also developed a line of advertising. The company at the time was putting out a sort of comic valentine in which negro characters were depicted using scrubbing brushes. The officers toned that up and produced a catalogue which was a revolution in the trade of scrub brush manufacturers and manufacturers of brushes similar to those of the Ox Fibre Brush Company. In other words, they gave to the trade somewhat of an education in the product they were making.

Mr. McEwen and Mr. Robinson, jr., worked all these things out and were practically like one organization. They worked in perfect harmony, and everything that was attempted was carried out in perfect accord. If one originated an idea, the other was willing to carry it out. It took some little time to get things going well, but after the start things went along famously.

J. K. Robinson, jr., president of the company, went to New York about a year after Mr. McEwen arrived in Frederick, so Mr. McEwen took charge of the factory from that time on until Mr. Crawford came with the company.

Mr. McEwen went to New York in 1911 or 1912 and has been there ever since, but it is his practice to continue to make frequent visits to the plant in Frederick.

John G. Crawford, referred to above, resides at Saunderstown, Rhode Island. He is and has been a clergyman of the Protestant

Episcopal Church for approximately five years, and has a parish at the present time in Rhode Island, including the towns of Wakefield, Saunderstown, and the mission of Shannock. Mr. Crawford is now the vice president and has been a director of the Ox Fibre Brush Company since 1914. His connection with the Ox Fibre Brush Company began in 1912. When Mr. Crawford was traveling in Europe, he received three cablegrams from Alfred McEwen, treasurer, offering him a position with the Ox Fibre Brush Company. Both men had worked together at the same time with the Western Electric Company at Chicago, Illinois. Mr. Crawford had
34 been first head draftsman and bookkeeper, and head draftsman at their factory at Anderson and was in charge of their Hawthorne shops. With the exception of one or two companies, Mr. Crawford had worked for all of the large electrical companies in the country—The Thompson-Hughes Company, the General Electric Company, the Westinghouse Electric Manufacturing Company, and the Simmons Company. In the drafting room of the Western Electric Mr. Crawford had direct supervision over about 400 draftsmen. In the Hawthorne shops he had direct supervision over 6,000 or 7,000 employees.

Mr. Crawford received his academic training in engineering at the Royal College of Science in Dublin, Ireland.

Mr. McEwen was employed with the General Electric Company as sales manager in charge of the local machinery sales at the same time that Mr. Crawford was with that company.

In 1912 Mr. Crawford took the position of factory manager at Frederick, Maryland, of the Ox Fibre Brush Company. When Mr. Crawford accepted employment with the corporation, the factory was in a chaotic state; it was operating very inefficiently, the company was not making much, if any, money, and the purpose for which Mr. Crawford was hired was to put the factory on a modern manufacturing basis, to see that the proper help were hired and the necessary machinery secured, and if any were designed to attend to that; and that up-to-date methods were installed to take effect in increased production and profits. To accomplish these things, Mr. Crawford revised the personnel of the factory where it was necessary to do so, altered the manufacturing methods where is was deemed advisable, and initiated and helped in the designing of special machinery relating to the manufacturing of the brushes. Mr. Crawford also altered the routing of the work through the factory to cut out lost motion and, in general, put the factory on a manufacturing basis. He saw that the basic rates of payment to the help were legitimate from the point of view of the company and also from theirs. The number of employees at that time was about 300, though it varied from time to time. The mechanical improvements consisted in evolving and installing machines which
35 were efficient and which would minimize the lost time spent for repairs and cut down the manufacturing cost. The output of the factory was very largely increased, but, of course, that took time.

Mr. McEwen and Mr. Robinson both made suggestions in these changes and approved practically all of them. In a word, they held the reins and issued orders, and Mr. Crawford would carry them out in the large items; but in the actual running of the factory, he did not disturb them with questions; that was his business.

Mr. Crawford left the employ of the Ox Fibre Brush Company in 1917. At that time, as factory manager, he was receiving a salary of $10,000 a year. After he left, the Ox Fibre Brush Company hired a man at a much lower salary than Mr. Crawford was getting. He was hired only as factory superintendent, not as factory manager. Mr. Crawford's duties after his departure were divided between Mr. McEwen in the New York office and Mr. Dertzbaugh in the factory. The shop was then in such a condition that Mr. McEwen could assume that management with a much smaller calibre man in the shop to look after the routine methods, so that the officers practically took over the general policy of shop management themselves and had a superintendent there to carry out their ideas. After Mr. Crawford left the company in 1917, he kept in touch with the affairs of the company on the average of once in six or eight weeks, either in the factory or in the New York office.

Mr. Robinson, sr., early decided that he would not advance any further funds to the business; that the officers should make it stand on its own bottom. They were confronted with the proposition of going to the banks and establishing a line of credit and had a great deal of trouble in getting it, but being a Frederick institution, and since it employed the maximum amount of labor that was employed in the town, the banks finally agreed to let the officers have a small line of credit, but the officers always had to endorse the paper personally.

Along about 1912 or 1913 the company had reached the limit of credit, and the two local banks would not extend any further credit. Since they were the only local source of supply, the officers went to New York and tried to borrow in New York, but they were
36 asked why they did not borrow at home. So Mr. Robinson, jr., and Mr. McEwen both advanced funds on their own credit.

Mr. Frank Dertzbaugh, as manager of the company, had charge of the company's banking arrangements in Frederick, Maryland. When he saw the need of money, and it was not forthcoming from the regular course of business, he sent a blank note to the New York executive officers, and they signed the same for the amount suggested as necessary, and invariably they signed it as officers of the company and endorsed it personally and returned it to Mr. Dertzbaugh, who thereupon deposited it to the company's credit at the bank, for the bank had made a rule that in order to pass by its board of directors, before credit would be extended, the paper would have to be endorsed personally by both Mr. McEwen and Mr. Robinson, who were men of large means and whose endorsements were

considered ample collateral for the company's loans. That arrangement continued up to recent date.

Counsel for petitioner then offered in evidence a statement showing the corporate bank loans personally guaranteed by J. K. Robinson, jr., president, and Alfred McEwen, treasurer, during the period 1908 to 1921, inclusive, which statement had previously been identified by Mr. Dertzbaugh and testified to by him as having been prepared from facts within his own knowledge and from his having charge of the company's banking arrangements, as follows:

Exhibit in evidence

Corporate bank loans personally guaranteed by J. K. Robinson, jr., president, and Alfred McEwen, treasurer

Year	Bank loans, notes payable guaranteed
1908	$27,000.00
1909	87,000.00
1910	68,250.00
1911	68,250.00
1912	84,949.25
1913	82,700.00
1914	98,050.00
1915	113,859.01
1916	92,550.00
1917	60,890.00
1918	57,890.00
1919	52,000.00
1920	15,000.00
1921	15,000.00

Counsel for respondent objected to the admission of said statement on the ground that it was immaterial and incompetent and was very remote evidence of the value of services of those persons to the corporation in question. Counsel for petitioner stated that it was material to show the type of service rendered; that the services were out of the course of normal and usual services rendered by officers; that it was one of the circumstances connected with their service; that these men were not financing their own enterprise, since they held less than 50% of the stock, the board member ruled as follows:

"The MEMBER. That is true, as you say, under certain circumstances, but it was not an incident to the employment, and the corporation would be indebted to them morally for those services in a certain way, but I do not see that that is the basis for greater compensation to any officer or employee. If that came in under regular services as these past exhibits seem to indicate, I can see the force of that, but I can not see the force of endorsing paper here as a service to the corporation for which a salary should be paid. I think I will sustain the objection to this offer.

* * * * * * *

"The MEMBER. I do not doubt but what that was a great benefit to the corporation, and my view of it is that it is not such service that calls for salary or remuneration in that way. That is the way I view it."

During the year 1920, and the years prior thereto, the company had been unusually successful.

Thereupon Mr. Crawford testified as follows:

38 Q. When do you recall the first time the question of additional compensation of these two men was brought to your attention?

A. I should say it came up off and on, about the summer of the preceding year, but never for action. It was discussed.

Q. Well, how did it come up?

A. It would come up at meetings when we were having board meetings; it would come up and be talked about and dropped. No motions were made and no actions were taken on it.

Q. What was the general discussion with respect to the allowance or nonallowance of additional compenation?

Mr. FISHER. I object to that as incompetent and immaterial. No action was taken, and no liability was accrued, and no final decision reached.

The MEMBER. You can not change the minutes.

Mr. SUTTER. We are not trying to do that, if your honor please.

The MEMBER. What is the purpose of it?

Mr. SUTTER. I am trying to show, if the court please, that it was recognized for five or six months prior to this that these men were entitled to additional compensation.

The MEMBER. He testified it was talked about. Now, he is asked to go into that conversation, or that talk. I think it is objectionable. The minutes speak for themselves as the last action, and the objection is sustained.

Mr. SUTTER. An exception, if your honor please.

The MEMBER. An exception may be noted.

In the year 1920 the factory had lost its heaviest technical adviser, to wit, Mr. Crawford, who left in 1917.

In the months immediately prior to May 7, 1920, Mr. Robinson and Mr. McEwen both rendered special services to the corporation. That year was a very busy year for both Mr. Robinson and Mr. McEwen, and they had negotiations up with two big plants that wished to sell out, one of them going so far as to make an offer to the Ox Fibre Brush Company to take over the management if it would do so without its paying anything. This was the Brommel Brush & Fibre Industry, located in Cincinnati. The negotiations were dropped in the middle or latter part of April, 1920. It was necessary for Mr. McEwen and Mr. Robinson to travel considerably in connection with these negotiations. They visited the plants in Cincinnati and did other work of that sort relating to the negotiations necessitated in considering this proposition.

39

A special meeting of the board of directors of the Ox Fibre Brush Company was held in New York on May 6, 1920. Mr. Crawford was elected to preside at that meeting. All the directors, except Emory L. Coblentz, were present. The stock of the company consisted of 9,000 shares. Of this, Mr. J. K. Robinson, jr., owned

about 1,850 shares, and, including the shares held by his wife and children, a total of about 1,600 shares; Mr. McEwen owned about 100 shares, and, including the shares held by his wife and children, a total of about 1,750 shares. At this meeting there were two main subjects up for consideration; one of them was the increased remuneration to the two chief executive officers of the company, and the other was the matter of declaring special dividends. Motions were made and carried, as appear in the minute book to authorize additional compensation to Mr. J. K. Robinson, jr., the president, and Alfred McEwen, the treasurer.

There were no adverse votes with respect to the additional compensation, nor was there any adverse discussion; the meeting was absolutely unanimous and in harmony.

Emory L. Coblentz, the director who was not present, resides at Frederick, Maryland. He is a banker and stockholder to the extent of 5% in 1920, in the Central Trust Company of Frederick, Maryland, and had been with said company since 1908. Prior to that time, he had some connection with other banks. Mr. Coblentz is also a practicing attorney, but does very little practicing. He is a director of the Valley Savings Bank of Middletown; vice president and director of the Union Manufacturing Company, of Frederick, Maryland; a director of the Economy Sale & Manufacturing Company, of Frederick; resident and director of the Frederick Hotel Company, which owns the Francis Scott Key Hotel in Frederick, and also an officer and director of other companies. For more than ten years he has been director of Ox Fibre Brush Company.

40 Mr. Coblentz was informed by notice and by personal communication from Mr. Dertzbaugh, the general manager of the company, of the purpose of the meeting. Being unable to attend, he wrote a letter to the secretary to be read at that meeting, which set forth his position on the question before the board of directors, as follows:

Exhibit in evidence

MAY 3RD, 1920.

WILLIAM A. EVANS, Esq.,
Secretary Ox Fibre Brush Comuany,
Guaranty Trust Building,
44th Street and 5th Avenue, New York.

MY DEAR SIR: Replying to your letter of the 30th ultimo, advising me of a special meeting of the board of directors of the Ox Fibre Brush Company to be held on Thursday, May 6th, at 9.30 a. m., I beg to advise that I have an appointment in Frederick on the evening of May 5th which I can not now cancel, and hence it will be impossible for me to reach New York in time for this meeting.

Mr. Dertzbaugh has explained to me that the purpose of this meeting is to consider and act upon a proposition for the granting of additional compensation amounting to $25,000 each to Mr. Robin-

son and Mr. McEwen for their past services to the company. I have so much confidence in the fairness of these two gentlemen in the management of the property and of their interest in all the stockholders that I feel they would make no proposition which was not thoroughly considered by them as being fair and equitable, and if I were present at this meeting I would gladly vote for such proposition for additional compensation as they think under all the circumstances is fair and equitable to all the parties interested.

Yours very truly,

_____.

In voting the amount of $24,000 as additional compensation for each of these men, one of the directors, Mr. Crawford, expressed their reasons as follows:

41 "When we took into consideration the services of the men in question, what they had been doing, what the company was when they took it over, what its financial condition was, what its standing was in the art, and then saw how the money we had invested was beginning to bring us in a very substantial return, and how the company had risen to the foremost rank in the business world of brush making; when we saw that we had just received a 50 per cent stock dividend on our stock, we thought that anything less than $24,000 would have been absolutely inadequate, and, besides, we had another object in view: We thought the best way to continue the prosperity that we had enjoyed was to make it worth these men's while to give us the same type of service. We also had one other matter in mind, that we could not get anything like the type and quality of service that the company was getting from these two men at the time, and if we went out into the open market to buy that we would have had to pay far more than their drawing account and the salary accounts of these two men represented."

On cross-examination, Mr. Crawford testified as follows:

Q. Did you make any personal investigation of what it might cost to employ others to come in?

A. I am perfectly familiar with that situation. I have been a factory executive in a rather large way for a good many years, and I know what the market value for such services are fairly well.

Q. Well, they paid this $24,000 out for 1920 over and above the fixed compensation of $12,000 in one case and $15,000 in the other?

A. Yes.

Q. You considered that fair and reasonable as compensation to equalize—proper compensation for services of the kind and character that they rendered?

A. May I answer that question in this way: I considered that if we had to go in the open market and hire that kind of services we would have had to pay $30,000 to $50,000 a year. Those men at that

time were not only taking care of the services of treasurer and president, they were handling all of the large purchases of our company, and they were directing the hiring of the personnel, as you
42 see, by the fact that they hired me. They were directing the policy of the company, and even directing the lines along which factory development should go. They were doing the work of probably five men in addition to the executive duties of president and treasurer.

Officers' salaries, gross sales, amounts carried to surplus after deducting officers' salaries and other expenses, dividends declared and paid, and the amount of capital stock outstanding for the years 1908 to 1914, inclusive, and 1918 to 1922, inclusive, were as follows:

	Officers' salaries	Gross sales	Net earnings, amount carried to surplus	Dividends declared and paid	Outstanding capital stock
1908	$6,000.00	Not shown.	$3,972.44	None.	$300,000
1909	6,000.00	$374,236.66	41,985.36	None.	275,000
1910	9,999.00	467,943.50	68,069.99	$8,686.50	288,000
1911	9,999.00	521,650.78	21,611.75	4,500.00	208,000
1912	9,999.00	596,010.57	52,012.74	4,500.00	300,000
1913	10,999.00	612,087.57	49,810.44	13,387.50	297,500
1914	16,000.00	596,856.83	28,591.95	4,462.50	297,500
No data furnished for 1915 to 1917.					
1918	25,384.64	1,068,641.46	132,679.16	56,576.00	483,400
1919	27,000.00	1,193,742.39	211,130.82	133,579.50	474,700
1920	75,000.00	1,273,474.72	158,753.67	(123,275.00 (300,000.00	Cash. Stock.
1921	27,000.00	980,376.56	128,745.07	94,388.00	900,000
1922	33,000.00	1,342,834.03	255,762.16	170,860.00	900,000

The officers' salaries, gross sales, net income before deducting officers' salaries, amounts carried to surplus after payment of salaries and other expenses, dividends declared and paid, and the amount of the capital stock outstanding for the year 1920 were as follows:

43

Officers' salaries (Pet. Ex. 2)	Gross sales (Pet. Ex. 2)	Net income before officers' salaries (Pet. Ex. 2 and 3)	Net earnings, amount carried to surplus (Pet. Ex. 3)	Dividends declared and paid (Pet. Ex. 4)	Outstanding capital stock (Pet. Ex. 1)
1920					
$75.00	$1,273,474.72	$233,753.67	$158,753.67	$123,275 (50% stock, $300,000)	$477,500

The percentage of officer's salaries to gross income, to net income before deducting salaries, and the percentage of net income after paying salaries and other expenses to the outstanding capital stock for the year 1920 were as follows:

	Officers' salaries to gross income (Pet. Ex. 2)	Officers' salaries to net income before deducting salaries (Pet. Ex. 2 and 3)	Net income after salaries to outstanding capital stock (Pet. Ex. 3)
1920	5.8%	32.09%	33.24%

As a stockholder and director of the company in 1920, Mr. Crawford did not feel that any part of the earnings attributable to his stock was being distributed to these men. That point was perfectly clear in the minds of the directors. They were simply handling the legitimate expenses of conducting the operations of the company. It was a matter of salary for services which were being rendered.

There was no adverse feeling expressed to the right of the officers to additional compensation in May, 1920, and the directors seemed to be quite willing to reward them for their good efforts, as they expressed it, that had been given by these officers to the business. The record of the company was opened and the history of the company considered by the directors. There was a discussion of the showing that had been made and the good work that had been done, and the directors thought the officers were entitled to compen-
44 station for the splendid way in which the company had been dragged from red figures into a very profitable investment for the stockholders.

After the meeting of the board of directors, at which it was resolved that additional compensation of $24,000 should be paid to J. K. Robinson and a like amount to Alfred McEwen, Mr. Dertzbaugh, who kept the books of the company and was general manager, received a signed copy of the resolution and made an entry on the books of the company, in May, 1920, charging profit and loss and expenses and crediting the personal accounts of Mr. Robinson and Mr. McEwen with $24,000 each. The total of $48,000, representing the extra compensation authorized by the minutes, was deducted from gross income of the corporation in computing the taxable net income for the year 1920 on its income and profits tax return, but this deduction was disallowed in an audit of the return by the Commissioner of Internal Revenue. The books of the corporation were kept on the accrual basis.

The respondent called no witnesses in rebuttal.

Thereupon counsel for both petitioner and respondent stated that they had no further or other evidence to present and rested the case.

The petitioner, Ox Fibre Brush Company, tenders and presents the foregoing as its statement of evidence in this case, all parts not essential to the decision of the questions presented by the petition for review being omitted, and prays that the same be approved by the

United States Board of Tax Appeals and made a part of the record in this cause.

R. S. DOYLE,
CHARLES D. HAMEL,
HARRY B. SUTTER,
Attorneys for Petitioner

Order settling statement of evidence

I hereby certify that the foregoing statement of evidence has been examined by me and found conformable to the truth, and contains all the evidence in the case, in narrative form, deemed essential to the decision of the question presented by the petitioner for review.

45 Where the testimony herein is set forth in the form of questions and answers, it is so set forth that the evidence might be clearly understood.

Each of the exceptions stated to have been taken by the attorney for the petitioner were so taken and were duly allowed and noted by the board, and in order that each and every one may be preserved and made of record this statement of the evidence is duly approved and signed and ordered to be made of record in the above-entitled cause this 14th day of May, 1928.

W. D. LOVE,
Member United States Board of Tax Appeals.

Before United States Board of Tax Appeals

OX FIBRE BRUSH COMPANY, PETITIONER
v.
DAVID H. BLAIR, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT
} Docket No. 8153

Agreement to Statement of Evidence Under Equity Rule 75

We have examined and read the foregoing 20 pages comprising all the evidence taken in the case of Ox Fibre Brush Company, petitioner v. David H. Blair, Commissioner of Internal Revenue, respondent, Docket No. 8153, in the United States Board of Tax Appeals, said evidence being stated in simple and condensed form, all parts not essential to the decision of the questions presented by the petition for review being omitted and the testimony of witnesses being stated in narrative form. And we agree that all parties hereto have received due and legal notice of said statement as required by Equity Rule No. 75, and we accept service of such notice and hereby waive further notice of the filing of the statement, and we agree that said statement as made may be approved by the board member hearing the case, without further notice to any party hereto, and that when so approved may be filed in the clerk's office and

become a part of the record for the purpose of the petition for review in said cause filed by Ox Fibre Brush Company, petitioner.

C. M. CHAREST,
Attorney for Respondent.

46 [Certificate to foregoing paper omitted in printing.]

Filed May 12, 1928

Before United States Board of Tax Appeals

OX FIBRE BRUSH COMPANY, PETITIONER
v.
DAVID H. BLAIR, COMMISSIONER OF INTERNAL REVENUE, respondent } Docket No. 8153

Præcipe for Transcript of record

TO THE CLERK OF THE UNITED STATES BOARD OF TAX APPEALS:

You will please prepare a transcript of record in this cause, and on or before May 26, 1928, transmit the same to the clerk of the United States Circuit Court of Appeals for the Fourth Circuit, and include in said transcript copies duly certified as correct of the following documents:

1. The docket entries of proceedings before the board in the above above entitled cause;
2. Pleadings before the board;
3. Findings of fact, opinion, and decision of the board;
4. Amended petition for review;
5. Statement of evidence as agreed upon.

Said transcript to be prepared as required by law and the rules of the United States Circuit Court of Appeals for the Fourth Circuit.

47-48 AGREEMENT TO PRÆCIPE

We hereby agree that the above and foregoing præcipe is correct; that the records, documents, papers, and proceedings therein set forth are sufficient for a complete record in this cause on appeal, and we hereby adopt the foregoing as a list designated by each of the parties to this cause to complete said transcript, and we hereby waive the issuance and service of notice upon any party hereto, and agree that said præcipe shall be obeyed by, and acted upon by, the clerk as fully and to all intents and purposes in the same manner as if said præcipe had been regularly filed and a true copy thereof served upon each party hereto.

R. S. DOYLE,
CHARLES D. HAMEL,
HARRY B. SUTTER,
Attorneys for Petitioner.
C. M. CHAREST,
Attorney for Respondent.

[Certificate to foregoing paper omitted in printing.]

49 In United States Circuit Court of Appeals for the Fourth Circuit

No. 2753

OX FIBRE BRUSH COMPANY, PETITIONER
versus
DAVID H. BLAIR, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On petition to review the decision of the United States Board of Tax Appeals

Minute entries

May 22, 1928, the transcript of record is filed and the cause docketed.

Same day, the appearance of Richard S. Doyle, Harry B. Sutter, and John Enrietto is entered for the petitioner.

Same day, the appearance of Mabel Walker Willebrandt, Assistant Attorney General, C. M. Charest, general counsel, Bureau of Internal, and L. M. Scott, special attorney, Bureau of Internal Revenue, is entered for the respondent.

July 5, 1928, twenty-five copies of the printed record are filed.

August 2, 1928, stipulation of attorneys as to the time for the filing of their respective briefs is filed.

50 September 27, 1928, the appearance of Morton P. Fisher, special assistant to the Attorney General, and Dorothy A. Moncure, attorney, is entered for the respondent.

Same day, stipulation of attorneys as to the time for the filing of respondent's brief and petitioner's reply brief is filed.

Argument of cause

November 13, 1928 (October term, 1928), cause came on to be heard before Parker and Northcott, Circuit Judges, and Coleman, District Judge, and is argued by counsel and submitted.

51 In United States Circuit Court of Appeals, Fourth Circuit

[Title omitted.]

(Argued November 13, 1928. Decided April 9, 1929)

Before PARKER and NORTHCOTT, Circuit Judges, and COLEMAN, District Judge.

Opinion

Filed April 9, 1929

52 COLEMAN, District Judge:

This is an appeal for review of a decision of the United States Board of Tax Appeals affirming the finding of the Commi

sioner of Internal Revenue that there was a deficiency of $24,091.60 in the income and profits tax for the calendar year 1920, paid by the petitioner, the Ox Fibre Brush Company, hereinafter called the company. The deficiency as claimed arose from the fact that the company had deducted from its net income the sum of $48,000.00, one-half of which having been voted in 1920 to the company's president as "extra compensation for his past services" and a like sum, by similar resolution, to the company's treasurer. The company claimed the right to make this deduction by virtue of section 234 (a) (1) of the revenue act of 1918 (40 Stat. 1057), which is as follows: "That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

"(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered * * *."

The material facts as disclosed by the evidence are as follows: The company, a West Virginia corporation, during the year 1920 and for many years prior thereto, had been engaged in the manufacture of brushes, its factory being located at Frederick, Maryland, with executive offices and sales headquarters in New York City and branch sales offices in St. Louis, Cincinnati, Philadelphia, and Boston. Mr. Robinson, the company's president during the year 1920, had served the company in this same capacity since 1906, and
53 Mr. McEwen, the treasurer in 1920, had held the same office since 1907. Both of these officers had devoted their entire time to the company's interests since 1907. Each year they had personally guaranteed bank loans of considerable size made to the company. Prior to 1917, a technical expert had managed the company's plant, for which he received $10,000 per annum, but in that year the president and treasurer assumed general management of the plant. The services of the technical expert were dispensed with, and in his place a factory superintendent was employed at a much lower salary. In addition to their regular executive duties, the president and treasurer handled all large purchases, directed all sales, the hiring of personnel, and also directed the general policies of the company. Prior to Mr. Robinson's and Mr. McEwen's administration of the business, it had been in a chaotic state and operated at a loss, but under their direction and control the gross sales of the company increased from $374,236.66 in 1909 to $1,273,474.72 in 1920; the net income increased from an operating loss of $3,972.44 in 1908 to net earnings, after deduction of salaries including the amounts here in question, of $158,753.67 in 1920. No dividends were paid until 1910, but were increased from $4,500 in 1911 and 1912 to $423,275 in 1920, represented by 50% stock dividend of $300,000 and cash dividends aggregating $123,275 or 25.98%, on the outstanding capitalization at the beginning of that year—that is to say, under the new management, the company advanced from the status of a poor competitor

with other corporations employing contract prison labor in the manufacture of brushes to a leading place in the brush trade. The percentage of officers' salaries to gross income for 1920 was 5.8%. The percentage of officers' salaries to net income, before deducting salaries, was 32.08%, and the percentage of net income, after paying salaries and all other expenses, to outstanding capital stock
54 was 33.44%. The net income in 1920—namely, $158,753.67, after deduction of all expenses including officers' salaries, represented a return of 21.13% on invested capital of $751,038.31, as determined by the Commissioner of Internal Revenue for that year. As a result of the bureau's disallowance of the $48,000 here in question, the taxable net income for 1920 of the company was $206,753.67, or a return of 27.53% on invested capital and surplus.

In 1919 and 1920, $12,000 and $15,000 had been paid as salaries to the president and treasurer, respectively. In 1918 their combined salaries were approximately $25,000. The record does not disclose what they received in 1915, 1916, and 1917, but in 1914 they together received $16,000; in 1913, $11,000; in the three preceding years, $10,000, before which they received $6,000. On May 6th, 1920, the board of directors at a meeting duly called unanimously voted to pay each of these officers additional compensation of $24,000. The following appears from the minutes of this meeting:

"This meeting having been specially called for the purpose of considering and acting upon the proposal for a grant of additional compensation to Mr. J. K. Robinson, jr., and to Mr. Alfred McEwen, for their past services to the company, * * *

"Resolved that this board hereby authorize and direct the payment of the sum of twenty-four thousand ($24,000) dollars to Mr. J. K. Robinson, jr., as extra compensation for his past services to this company as an officer thereof and in any other capacity, the same to be paid when, in the discretion of the officers, funds of this corporation for this purpose are available.

Resolved that this board authorizes and directs the payment of the sum of twenty-four thousand ($24,000) dollars to Mr. Alfred McEwen as extra compensation for his past services to this company as an officer thereof and in any other capacity, the same to be paid when in the discretion of the officers funds of this corporation for this purpose are available."

55 The petitioner's books were kept on an accrual basis, and during the month of May, 1920, proper entry was made therein, crediting the accounts of the president and the treasurer with the additional compensation voted, as aforesaid, and charging the expense accounts therewith.

The president and treasurer and their immediate families owned approximately 36% of the stock of the company. The remaining stock was mostly owned by the company's employees.

On this evidence the Board of Tax Appeals found, first, that the additional compensation voted to the company's president and

treasurer in 1920 was intended to be as and for, and was as and for, salaries for the year 1920; second, that the action of the company's board of directors in so voting did not raise a presumption that the extra compensation was in fact reasonable for services actually rendered; and third, that such extra compensation was in excess of reasonable compensation for services performed in 1920 on the ground that the duties performed were not materially different from those performed in preceding or succeeding years for which the compensation received was, the board asserted, not shown to have been inadequate, although it was conceded that the officers were efficient and brought prosperity to the company and that the additional compensation was a merited recognition by the company of their valuable services rendered prior to 1920. There are fourteen assignments of error, which, summarized, question all three of these findings. We will consider these findings in the order stated.

First, to say that the additional compensation voted to the company's president and treasurer in 1920 was intended to be as and for, and was as and for, salaries for the year 1920, is to torture the very language of the resolutions themselves. The payment to each officer is expressly stated to be "extra compensation for his
56 past services," not merely measured by such services. The wording could scarcely be clearer. Whether, if the resolution had been differently worded—for example, if the extra compensation had been voted "to make up for lack of same in past years"—the present finding of the Board of Tax Appeals on this point might have been justified; it is not necessary for us to decide. See Vaughn & Barnes, Inc., 6 B. T. A. 1279. Therefore, this first conclusion of the board we find to be erroneous and not binding. While the board's findings of primary facts are conclusive, the court must inquire into other facts in order correctly to determine whether the board's conclusion is supported by the evidence—namely, whether it is in accordance with law. We find no evidence whatsoever to support this conclusion. The jurisdiction of this court to review decisions of the Board of Tax Appeals is conferred by the revenue act of 1926 (26 U. S. C. A. sec. 1226 (b)), which is as follows: "Upon such review, such courts [circuit courts of appeal] shall have power to affirm or, if the decision of the board is not in accordance with law, to modify or to reverse the decision of the board * * * as justice may require." As was said in Bishoff vs. Commissioner, 27 F. (2d) 91, 92;

"This provision is within the trend of recent legislation respecting fact-finding tribunals with special judicial powers, such as the Federal Trade Commission, whose 'findings of fact, if supported by testimony, are made conclusive (Comp. Stat. sec. 8836 a–k (15 U. S. C. A. secs. 41–51); Curtis Pub. Co. v. Federal Trade Commission [C. C. A.], 270 F. 881, 911), and is generally regarded, because of the power to modify or reverse such of the board's decisions as are 'not in accordance with law,' as conferring upon the designated

appellate courts jurisdiction to review not questions of fact, such as complicated accounts and disputed values, but only matters of law such as are raised by writ of error on review of a judgment
57 entered on the verdict of a jury. Avery v. Commissioner (C. C. A.), 22 F. (2d) 6; Brown v. Commissioner (C. C. A.), 22 F. (2d) 797. Even accepting as conclusive the board's findings of primary facts, it sometimes happens that the reviewing court must inquire, as on writ of error, into the ultimate fact finding in order correctly to determine whether the decision is validly supported by evidence and therefore is 'in accordance with law.'"

See also Royal Packing Co. vs. Commisisoner, 22 F. (2d) 536.

Turning to the Board of Tax Appeals' second conclusion we are likewise forced to declare that to be erroneous. The action of the board of directors of a corporation in voting salaries for any given period is entitled to the presumption that such salaries are reasonable and proper. This presumption, however, is not conclusive. Becker Bros. vs. United States, 7 F. (2d) 3. In other words, the payment of large salaries to officers may well prompt an inquiry into the question whether the amounts paid as salary are such in fact, rather than a distribution of profits in the guise of salary. The statute imposes two requirements: First, that the proposed allowance shall be a necessary expense, and second, that it shall be reasonable. If the allowance has no substantial relation to the measure of officers' services and is utterly disproportionate to their value, it is not in reality payment for services and so can not be regarded as "ordinary and necessary expenses." See Botany Worsted Mills vs. United States, decided by the Supreme Court January 2nd, 1929; United States vs. Philadelphia Knitting Mills Co., 273 Fed. 657. Likewise, the allowance is not to be permitted if and to the extent that as compensation it is relatively unreasonable, even though not of such an extraordinary, unusual, or extravagant amount as to condemn it entirely as in no sense compensation for services. The prima facie presumption in favor of the action which a corporation has taken in cases of this kind has repeatedly been recognized by
58 the Board of Tax Appeals itself. For example see Collins, McCarthy Candy Co. vs. Commisisoner, 4 B. T. A. 1280; Standard Silk Dyeing Co. vs. Commissioner, 9 B. T. A. 648. This presumption is in no wise inconsistent with the principle that the burden of proof rests upon the taxpayer. W. K. Henderson Iron Works & Supply Co. vs. Blair, 25 F. (2d) 538, and cases cited. The taxpayer in the present case has, we think, fully sustained the burden of proof for the reasons hereinafter explained.

It follows from what has been said that it is unnecessary to pass upon the correctness of the board's third conclusion—namely, that the extra compensation was in excess of reasonable compensation for services performed in 1920, except in so far as such determination may assist in deciding whether the present deductions are reasonable for past years; but it becomes necessary first to decide whether deductions for past years are permissible under the statute.

It is our conclusion that such deductions are permissible. The language of the statute with respect to allowable deductions is "all

the ordinary and necessary expenses *paid or incurred* during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services *actually rendered.*" (Italics inserted.) The statute does not limit its application to services rendered within the taxable year. The test of deductibility lies in the answer to the question: In what year has a fixed liability for the payment arisen? Only for such year is the payment deductible, and, therefore, it is not to be allocated over other years in which the services may have been rendered. This is quite different from saying that, where, as here, books are kept on the accrual basis the deduction may not include compensation, fixed or paid in the taxable year, for services rendered in prior years.

In defining the terms "paid or incurred" and "paid or accrued" the act (sec. 200) merely says that they "shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212"—that is, on the cash or the accrual basis or by such other method as clearly reflects the income. But a salary can neither be "incurred" nor can it have "accrued" until the payor's liability for the same has been fixed—that is, until the company, in the present case, has voted it payable. For this reason, expenses of this kind are not to be confused with taxes, and therefore such decisions as *United States* vs. *Anderson*, 269 U. S. 422, upon which the Government relies, are not controlling. In that case the Supreme Court held that the tax imposed by the munitions tax act of 1916 was a proper accrual and was deductible for 1916, though it was not required to be paid until 1917 where all the events which *fixed* the amount of the tax and *determined the liability* occurred in 1916, since the gross income for 1916 could not have been determined without deducting therefrom the reserve set up for the munitions tax as a part of the total cost and expense attributable to the production of income for that year.

As for the case of *Illinois Central, etc., R. R.* vs. *Interstate Commerce Commission*, 206 U. S. 441, which the Government has also stressed in support of its contention, merely to state what the court there held—that "instrumentalities which are to be used for years should not be paid for by revenues of a day or year" (p. 463)—is to refute completely its application to the present facts. Current salaries are not capital investments. We are not unmindful of the fact that the Seventh Circuit, in *W. S. Bogle & Co.* vs. *Commissioner*, 26 F. (2d) 771, in construing a similar provision of the income tax act of 1916, held that the Board of Tax Appeals properly refused to allow a deduction for salary payment made to a corporation's president as compensation for previous years, saying (page 772): "This statute was intended to allow ordinary and necessary expenses paid and incurred within the year for officers' salaries. Where a salary has been fixed and fully paid for one year, it can not be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year." Prima facie, this statement would appear to be in conflict with the principle that we here announce, but it may not be so intended, because it is to be noted that the court speaks of a salary "fixed and

fully paid" for a previous year, implying, as it would seem, that the additional compensation rendered the total salary unreasonable and excessive. At least the opinion is so phrased as to leave room for doubt on this point.

So also the case of W. K. Henderson Iron Works & Supply Co. vs. Blair, supra (Court of Appeals, District of Columbia), decided merely that a salary voted in one year for services performed in a preceding year and disallowed as a deduction for such preceding year is likewise not allowable for the year in which voted in the absence of proof to sustain its reasonableness.

That the practice here sanctioned may be subject to abuse is not sufficient to condemn it. Whether there is actual abuse becomes a question of fact in each case. A corporation with a large surplus in a given year may attempt to dispose of that surplus in the guise of salaries and thereby evade its full tax burden, but there is no evidence that such occurred in the present case; nor is there any bad faith to be deduced from the fact that these officers, together with their families, owned approximately 36% of the company's stock. The additional compensation was voted to them not because they were stockholders, but because they performed services as employees of the corporation which its board of directors believed to have been peculiarly valuable. If rigid rules of accounting are allowed to supplant that reasonable amount of flexibility which must, from the very nature of things, go hand in hand with the vicissi-
61 tudes of business, loyalty, and ambition on the part of employees will become deadened, and those persons whose services are essential to the success of a given enterprise will be unavailable at the very time when they are most needed. For a corporation to defer payment of full compensation to its employees in times of stress is no different in principle from the deferring of any of its other obligations. Both must be met in due course. Tax laws should aim to encourage, not to oppose this result, and should be so construed unless clearly expressive of a contrary intent.

In the present case the fact that the prior years are not specifically designated is not material, because evidence as to which years were referred to is not lacking. In 1917, through the reorganization which the president and treasurer had brought about, the company was put upon a paying basis and from then on the business became increasingly successful. In that year they took over the general management of the factory, and in addition to their regular executive duties handled all large purchases, directed all sales, the hiring of the personnel, and all questions of general policy. It further appears that shortly prior to May 7th, 1920, when the resolutions in question were passed, these officers had rendered special services to the corporation looking toward a possible merger with other companies, and at about this time the question of additional compensation was broached, but definite action thereon was postponed.

The Government appears to rely upon the fact that the corporation's books were kept on an accrual basis and not on a receipts and disbursements basis. It argues (referring to section 212 (b) of the act of 1918) that the accrual basis having been adopted, it must be consistently followed in a manner which clearly reflects income, and that expenses can only be deducted in the year to which they are attributable. With this statement we entirely agree, but the
62 method of bookkeeping makes no difference in the present situation. "To incur" means "to become liable or subject to." While an obligation that has accrued may also be said to be synonymous with one that has been incurred, the fact remains that there would have been no authority to enter the salaries in the present case as accrued until they had been voted or fixed. Under the accrual system, an expense accrues when all events have occurred from which liability is determined and has become fixed, even though payment be not yet due. That is to say, the basic idea is that the books shall immediately reflect obligations and expenses definitely incurred, and income definitely earned, without regard to whether payment has been made or is due. This was the theory upon which the case of United States vs. Anderson, supra, was decided. Thus, when in the present case the Government argues that if a resolution, authorizing additional compensation, be passed subsequent to the year in which the services to be compensated were rendered, the corporation must allocate the payment to the proper years and file amended returns for those years claiming the deduction in the amended return, it misconceives the basic idea of the accrual plan.

The principle has been clearly stated by the Board of Tax Appeals in a number of cases. For example, in the appeal of Vander Kamp Holland Dutch Bakers, 2 B. T. A. 1247, the board rightly held that additional compensation voted to a company's officers in 1920 for 1919 services was not deductible from 1919 income, saying (p. 1251): "It remains to determine in what year the deduction is to be allowed. Was the obligation incurred in the year when the services were rendered or was it incurred when the additional compensation was voted? Until it was voted, there was nothing more than a moral obligation; there was no legal obligation which could be enforced. We must accordingly hold that the $7,000 of additional compensation, voted in 1920 for services rendered in 1919,
63 was an obligation incurred in 1920 and is deductible in that year and not in 1919." To the same effect see appeal of Arter Paint & Glass Co., 2 B. T. A. 1256; appeal of Randall Bros. Inc., 4 B. T. A. 291; Roubaix Mills Inc., 7 B. T. A. 877. Relying upon these and similar decisions, the Bureau of Internal Revenue, in 1927, adopted regulations in conformity with what was there said. General Counsel's Memorandum 941, Internal Revenue Cumulative Bulletin, Vol. VI, No. 1, page 205 (1927). We are unable to reconcile the above-mentioned decisions of the board and the ruling of

the bureau with other decisions of the board, or with the position which it has taken in the present case.

We now come to the final question to be decided, namely, whether the additional salaries were reasonable compensation for services rendered prior to 1920. The board in its opinion states that "there is nothing in the record to indicate that additional salaries might be expected or would be granted in the future, and there is nothing to indicate that the duties performed were materially different from those performed in the preceding or succeeding years. It is not intimated that the compensation received prior to 1920 was inadequate. Under these circumstances we are of the opinion that the salaries paid by the petitioner to its officers in years prior to and subsequent to 1920 is the best evidence of their reasonableness and their value to the petitioner in that year." We have already shown the error into which the board fell in considering the additional compensation from the aspect of its reasonableness as salary payments for the year 1920. We have also pointed out that the evidence clearly indicates that the duties performed by the president and treasurer were materially different in the three years prior to, as well as in 1920, from what they had previously been; and also that there was very definite intimation in 1919 that these officers were entitled to
64 recognition for the part which they had played in making the business so successful. So from no angle can we accept the aforesaid finding of the board as properly reflecting the evidence in the case. If, as appears, during the years 1917, 1918, and 1919, the duties of both the president and treasurer were doubled, and satisfactorily performed, is it reasonable to conclude that each were not entitled for services in each of these years to an additional compensation of $8,000—that is, to one-third of $24,000 voted to each in 1920, or that, a fortiori, these allowances would not have been reasonable if prorated over a greater number of years? We think not, especially in view of the fact that salaries generally were being advanced during this period, because of the very radical advance in the cost of living. The company's board of directors unanimously declared in good faith that the services rendered were worth the additional compensation. Such action, as we have seen, raises a presumption of reasonableness, which has not been overcome. No testimony whatever was offered on behalf of the commissioner in rebuttal.

The gross income of the company in 1918 and 1919, as well as in 1920, exceeded $1,000,000. Adopting, merely for the sake of illustration, the theory of the board of tax appeals that the additional allowances were for services in 1920, the total salaries paid to these officers in that year were $75,000, or less than 6% of the gross income. After deduction of these salaries and all other expenses, the return to stockholders exceeded 33%. While, of course, each case must be determined upon its own peculiar facts, these percentages obviously do not reflect any impropriety in the allowances in question. See United States vs. Reitmeyer, 11 F. (2d) 248; Wood &

Ewer Co. vs. Ham, 14 F. (2d) 995. This being true, when we divide and distribute these allowances equally over a period of three or more years, and add them to the salaries paid during those
65-66 years, there is no ground for argument that for services in any of those years the remuneration has been unreasonable.

In view of what we have said it becomes unnecessary to consider the relation of officers' salaries to outstanding capital stock for the year 1920. Nor is what the corporation did in the matter of salaries subsequent to 1920 pertinent to the present inquiry. The fact that the additional compensation was voted to the president and treasurer, respectively, as officers of the company "and in any other capacity," does not, we think, create any just ground for questioning the good faith or reasonableness of the corporate action, especially in view of the admittedly multifarious duties which the two officers performed in rehabilitating the business.

In view of our conclusions, it becomes unnecessary to consider those assignments of error which relate to the exclusion of certain evidence favorable to the company's contention.

The decision of the Board of Tax Appeals not being in accordance with law, because not supported by the evidence, is therefore reversed.

67 IN UNITED STATES CIRCUIT COURT OF APPEALS, FOURTH CIRCUIT

No. 2753

OX FIBRE BRUSH COMPANY, PETITIONER,

vs.

DAVID H. BLAIR, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On petition to review the decision of the United States Board of Tax Appeals

Judgment

Filed and entered April 16, 1929

This cause came on to be heard on the petition to review, and the transcript of the record of the proceedings of the said United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof it is now here ordered and adjudged by this court that the decision of the said United States Board of Tax Appeals in this case be, and the same is hereby, reversed, and that this case be, and the same is hereby, remanded to the said United States Board of Tax Appeals for further proceedings in accordance with the opinion of the court filed herein.

JOHN J. PARKER,
U. S. Circuit Judge.

APRIL 16th, 1929.

68 In United States Circuit Court of Appeals

Order staying mandate

Filed May 7, 1929

Upon the application of the respondent, by C. M. Charest, Esq., general counsel, Bureau of Internal Revenue, and for good cause shown,

It is ordered that the mandate of this court in the above case be, and the same is hereby, stayed pending the application of the respondent in the Supreme Court of the United States for a writ of certiorari to this court, unless otherwise ordered by this or the said Supreme Court, and provided said application is filed in the said Supreme Court within 30 days from this date.

May 7, 1929.

JOHN J. PARKER,
U. S. Circuit Judge.

In United States Circuit Court of Appeals

Order further staying mandate

Filed May 29, 1929

Upon the application of the respondent, by Mrs. Mabel W. Willebrandt, Assistant Attorney General, and Callom B. Jones, assistant U. S. attorney for the Eastern District of Virginia, and for good cause shown.

It is ordered that the mandate of this court in the above case be, and the same is hereby, further stayed pending the application of the respondent in the Supreme Court of the United States for a
69 writ of certiorari to this court, unless otherwise ordered by this or the said Supreme Court, and provided said application is filed in the said Supreme Court within 30 days from June 6, 1929.

May 29, 1929.

EDMUND WADDILL, JR.,
Senior Circuit Judge.

[Clerk's certificate to foregoing transcript omitted in printing.]

70 In United States Circuit Court of Appeals

Order substituting party respondent

On motion of counsel for the respondent, consented to by counsel for the petitioner, in the above case,

It is ordered that Robert H. Lucas, present Commissioner of Internal Revenue, be substituted as party respondent in place and stead of David H. Blair.

July 1, 1929.

JOHN J. PARKER,
U. S. Circuit Judge Presiding.

[Certificate to foregoing paper omitted in printing.]

71 Supreme Court of the United States

Order allowing certiorari

Filed October 21, 1929

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fourth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[Indorsement on cover:] File No. 34,381. U. S. Circuit Court of Appeals, Fourth Circuit. Term No. 250. Robert H. Lucas, Commissioner of Internal Revenue, petitioner, vs. Ox Fibre Brush Company. Petition for writ of certiorari and exhibit thereto. Filed July 15, 1929. File No. 34,381.

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FILE COPY

Office Supreme Court, U. S.
FILED
JUL 15 1929
CHARLES ELMORE CROPLEY
CLERK

No. 250

In the Supreme Court of the United States

OCTOBER TERM, 1929

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

OX FIBRE BRUSH COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

U.S. GOVERNMENT PRINTING OFFICE: 1929

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In the Supreme Court of the United States

OCTOBER TERM, 1929

No. ——

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

OX FIBRE BRUSH COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

PETITION

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit entered in the above cause on April 16, 1929, reversing the decision of the United States Board of Tax Appeals.

STATEMENT

This case reached the Circuit Court of Appeals on the petition of the respondent, Ox Fibre Brush Company, for a review of the decision of the Board of Tax Appeals in determining an additional tax

upon respondent's income and profits taxes for the calendar year 1920. (R. 25.)

The question in the case is whether extra compensation paid to the president and treasurer of taxpayer corporation in 1920, pursuant to resolutions of its board of directors passed in that year, for services rendered in prior years, is deductible in that year as an ordinary and necessary expense in carrying on the business (taxpayer's books being kept upon the accrual basis). (R. 17.)

J. H. Robinson, Jr., and Alfred McEwen were, during 1920, and had been since 1905 and 1907, respectively, president and treasurer of taxpayer corporation. When they assumed control of the corporation in 1907 the factory was in a chaotic state and operated at a loss. In a large measure due to their efforts, the corporation progressed to a position among the foremost in the brush trade and was frequently urged by competitors to buy out or combine with the latter. (R. 15.)

During the entire period aforesaid Robinson and McEwen devoted all of their time to the promotion of taxpayer's interests, performing their duties primarily at the executive offices and living in or near New York. From 1917 to and including 1920, in addition to their regular duties they handled all large purchases, directed all sales, directed the hiring of personnel, and directed the policies of respondent and lines of factory development, including the general management of the factory. (R. 15, 31–35.)

The annual salaries of Robinson and McEwen for 1920 were $12,000 and $15,000, respectively. Respondent's board of directors at a meeting held May 6, 1920, unanimously voted to pay Robinson and McEwen additional compensation of $24,000 each as extra compensation for their past services to the company. The minutes of the meeting, so far as pertinent, are as follows (R. 16):

> This meeting having been specially called for the purpose of considering and acting upon the proposal for a grant of additional compensation to Mr. J. K. Robinson, Jr., and to Mr. Alfred McEwen, for their past services to the company, * * *.
>
> *Resolved,* That this Board hereby authorize and direct the payment of the sum of Twenty Four Thousand ($24,000) Dollars to Mr. J. K. Robinson, Jr., as extra compensation for his past services to this company as an officer thereof, and in any other capacity, the same to be paid when in the discretion of the officers, funds of this corporation for this purpose are available.
>
> *Resolved,* That this Board authorizes and directs the payment of the sum of Twenty Four Thousand ($24,000) Dollars, to Mr. Alfred McEwen as extra compensation for his past services to this company as an officer thereof and in any other capacity, the same to be paid when in the discretion of the officers, funds of this corporation for this purpose are available.

Proper book entries were made charging expense and crediting the accounts of the president and treasurer with the additional compensation voted and paid. (R. 17, 44.)

The Commissioner of Internal Revenue disallowed the deduction of the extra compensation totaling $48,000 as an expense for the year 1920. (R. 18.)

The Board of Tax Appeals took the view that the extra compensation was intended as salary for the year 1920, but that the impelling influence in determining the amount to be paid was the services rendered prior to that year. (R. 19.)

In the Circuit Court of Appeals, the Commissioner took the position that the extra compensation so voted was in consideration of services rendered in years prior to 1920 and not for 1920 services. The court accepted this view of the facts, the opinion reading as follows (R. 51):

> First, to say that the additional compensation voted to the Company's president and treasurer in 1920 was intended to be as and for, and was as and for, salaries for the year 1920, is to torture the very language of the resolutions themselves. The payment to each officer is expressly stated to be "extra compensation for his past services," not merely *measured* by such services. The wording could scarcely be clearer. (Italics supplied by the court.)

There appears to be no evidence to sustain the view of the Board that the extra compensation was

intended as 1920 salary, and the Board's conclusions in that respect are not only contradicted by the resolution of the board of directors already quoted, but also by evidence introduced by the taxpayer. A letter of Mr. Coblentz, one of the directors (R. 40), shows that he believed that the compensation was for past services, and an examination of the testimony of Mr. Crawford, another director (R. 41, 43–44), confirms that conclusion.

Adopting the view that the compensation was for services performed in prior years, it is conceded on behalf of the Commissioner that the payments were reasonable for such services. The sole question is, therefore, whether they were properly deductible in 1920. It is that question which was decided by the Circuit Court of Appeals.

If the deduction is disallowed, the resultant increase in tax for 1920 will amount to $24,091.60. (R. 24.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred in deciding that, where taxpayer's books were kept upon the accrual basis, compensation paid to officers of taxpayer corporation in 1920 (pursuant to resolutions of board of directors passed in that year) for services rendered in prior years was deductible in 1920 as an ordinary and necessary expense in carrying on the business in determining income and excess profits taxes for that year.

REASONS FOR GRANTING THE WRIT

(1) The decision in the present case is in conflict with the decision of the United States Circuit Court of Appeals for the Seventh Circuit in the case of *W. S. Bogle & Co.* v. *Commissioner,* 26 F. (2d) 771. The latter court decided (p. 772):

> Where a salary has been fixed and fully paid for one year, it can not be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year.

(2) The decision of the Circuit Court of Appeals in the instant case approves a deduction for the year 1920 of an expenditure which had no relation to 1920 income and is out of harmony with the decision of this Court in *United States* v. *Anderson,* 269 U. S. 422, 440. In that case the purpose of Congress in providing for tax returns on an accrual basis was stated in the following language (p. 440):

> It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.

(3) The question is of present importance in administering the tax laws since it is involved in cases now pending in the courts, the Board of Tax Appeals and before the Bureau of Internal Revenue. Without a decision of this Court, the Commissioner of Internal Revenue is unable to determine the proper principle to be applied to such cases, and an acceptance of the decision in the present case would leave the matter in confusion. Although existing Revenue Acts no longer include excess-profits taxes, nevertheless the possibility of reductions in surtaxes or additional exemptions of earned income of individuals, as well as of changed rates as applied to corporation income taxes, indicate the probable continuing importance of the question.

Wherefore, it is respectfully submitted that the petition should be granted.

CHARLES E. HUGHES, Jr.,
Solicitor General.

JULY, 1929.

BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The opinion of the United States Circuit Court of Appeals is reported in 32 F. (2d) 42 and will also be found in the record (p. 49).

The findings of fact and opinion of the Board of Tax Appeals (R. 15) are reported in 8 B. T. A. 422.

JURISDICTION

The order of the Circuit Court of Appeals affirming the decision of the Board of Tax Appeals was entered on April 16, 1929. (R. 57.)

Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925. (See also decision of this Court in *Old Colony Trust Co.* v. *Commissioner of Internal Revenue,* No. 130, October term, 1928.)

QUESTION PRESENTED

Where extra compensation has been paid to officers of taxpayer corporation in 1920 (pursuant to resolutions of its board of directors passed in that year) but where such compensation is in consideration of services rendered in prior years, is such compensation deductible in 1920 as an ordinary and necessary expense in carrying on the business (taxpayer's books being kept upon the accrual basis)?

STATUTE INVOLVED

The Revenue Act of 1918, c. 18, 40 Stat. 1057, provides in part:

> SEC. 212. (b) The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect income, the computation shall be made upon such basis and in such manner as in the opinion of the Commis-

sioner does clearly reflect the income. * * *

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered * * *.

STATEMENT

A statement of the facts and of the errors relied on will be found in the petition.

ARGUMENT

The Circuit Court of Appeals holds that since the corporation's books were kept on an accrual basis, and the extra compensation was not voted by its board of directors until 1920, an application of the ordinary rule that expenses due will not accrue until all of the factors material to the liability have become fixed necessitated the conclusion that such compensation accrued in 1920, although the court recognized that it was paid for services rendered in prior years. (R. 51.)

The court, in its literal adherence to the accrual theory, closes its eyes to the requirement of Section 212 (b) of the Revenue Act of 1918, *supra*, that net income shall be computed according to taxpay-

er's regular method of accounting, if that accounting method clearly reflects income; but that, if it does not, the computation is to be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect income.

The basic purpose is always the clear reflecting of income. This was recognized in *United States* v. *Anderson,* 269 U. S. 422, 440, where this Court stated that the purpose of Congress in permitting returns on other than a cash basis was to enable taxpayers to make their returns on scientific accounting principles by charging against income earned during the taxable period the expenses properly attributable to the process of earning income during that period.

In the present case, the extra compensation was earned in years prior to 1920. It had no relation whatever to the earning of income in 1920. Its deduction in that year is sought solely because the board of directors delayed action until that time.

If the taxpayer's contention is sound it results that the directors could have chosen arbitrarily any year subsequent to those in which the compensation was actually earned. Following this contention to its logical conclusion would enable corporations to deduct expenses for salaries when and as they choose. Such expenses might be shifted from year to year or averaged in whatever way expediency might dictate. Such expediency might well dictate the selection of years which would result in a lower

tax. In years in which excess profits taxes were levied this result could be accomplished by concentrating expenses in a single year in order to bring income to a lower classification in the graduated rating. In any period of decreasing rates of taxes the result could be accomplished by delaying the payment of large salaries until years of lower rates, thereby benefiting the individuals receiving compensation from close corporations.

Arbitrary shifting of expenses, therefore, results in failure clearly to reflect income for tax purposes. The Circuit Court of Appeals for the Seventh Circuit foresaw this difficulty. In *W. S. Bogle & Co. v. Commissioner*, 26 F. (2d) 771, that court said (p. 772):

> Where a salary has been fixed and fully paid for one year, it can not be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year.

The decision in the *Bogle case, supra,* is in direct conflict with the present case. The court in the instant case recognizes at least a *prima facie* conflict, but suggests that since in the *Bogle case, supra,* the court spoke of a salary "fixed and fully paid," there may be implied from that statement the fact that the additional compensation was unreasonable. Nothing in the Bogle opinion suggests such a basis for the decision, and the opinion in the present case concedes the suggested distinction to be a doubtful one. (R. 54.)

The result of the conflict of decision leaves in doubt the proper course to be followed by the Commissioner with respect to an important problem in the administration of the tax laws.

CONCLUSION

Because of the conflict of decisions involving a principle of present importance in administering the income tax laws, it is urged that this Court grant the petition in order that there may be a conclusive determination of the question.

Respectfully submitted.

CHARLES E. HUGHES, Jr.,
Solicitor General.

MORTON P. FISHER,
Special Assistant to the Attorney General.

DOROTHY A. MONCURE,
Attorney.

JULY, 1929.

U. S. GOVERNMENT PRINTING OFFICE: 1929

FILE COPY

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No. 250

In the Supreme Court of the United States

OCTOBER TERM, 1929

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

OX FIBRE BRUSH COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1929

No. 250

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

OX FIBRE BRUSH COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The findings of fact and opinion of the United States Board of Tax Appeals (R. 8) are reported in 8 B. T. A. 422.

The opinion of the United States Circuit Court of Appeals (R. 32) is reported in 32 F. (2d) 42.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 16, 1929. (R. 41.) Petition for certiorari was filed July 15, 1929. (R. 43.) Certiorari was granted October 21, 1929. (R. 43.)

Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where taxpayer's books are kept upon the accrual basis, and where extra compensation has been paid to officers of taxpayer corporation in 1920 (pursuant to resolutions of its board of directors passed in that year), but where such compensation is for services rendered in prior years, is such compensation deductible in 1920 as an ordinary and necessary expense in carrying on the business?

STATUTE INVOLVED

The Revenue Act of 1918, c. 18, 40 Stat. 1057, 1064, 1065, 1077, provides in part:

> SEC. 212. (b) The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *
>
> * * * * *
>
> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable

year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered * * *;

* * * * *

STATEMENT

This case reached the Circuit Court of Appeals on the petition of the respondent, Ox Fibre Brush Company, for a review of the decision of the Board of Tax Appeals in determining an additional tax upon respondent's income and profits for the calendar year 1920. (R. 16.)

J. K. Robinson, Jr., and Alfred McEwen were, during 1920, and had been since 1905 and 1907, respectively, president and treasurer of taxpayer corporation. When they assumed control of the corporation in 1907 the factory was in a chaotic state and operated at a loss. In a large measure due to their efforts, the corporation progressed to a position among the foremost in the brush trade and was frequently urged by competitors to buy them out or to combine with them. (R. 9.)

During the entire period aforesaid Robinson and McEwen devoted all of their time to the promotion of taxpayer's interests, performing their duties primarily at the executive offices and living in or near New York. From 1917 to and including 1920, in addition to their regular duties they handled all large purchases, directed all sales, directed the hiring of personnel, and directed the policies of

respondent and lines of factory development, including the general management of the factory. (R. 9, 19–23.)

The annual salaries of Robinson and McEwen for 1920 were $12,000 and $15,000, respectively. (R. 10.) Respondent's board of directors at a meeting held May 6, 1920, unanimously voted to pay Robinson and McEwen additional compensation of $24,000 each as extra compensation for their past services to the company. The minutes of the meeting, so far as pertinent, are as follows (R. 10):

> This meeting having been specially called for the purpose of considering and acting upon the proposal for a grant of additional compensation to Mr. J. K. Robinson, Jr., and to Mr. Alfred McEwen, for their past services to the company, * * *
>
> Resolved that this board hereby authorize and direct the payment of the sum of twenty-four thousand ($24,000) dollars to Mr. J. K. Robinson, jr., as extra compensation for his past services to this company, as an officer thereof and in any other capacity, the same to be paid when, in the discretion of the officers, funds of this corporation for this purpose are available.
>
> Resolved that this Board authorizes and directs the payment of the sum of twenty-four thousand ($24,000) dollars, to Mr. Alfred McEwen as extra compensation for his past services to this company as an officer thereof and in any other capacity, the same

> to be paid when in the discretion of the officers, funds of this corporation for this purpose are available.

Proper book entries were made charging expense and crediting the accounts of the president and treasurer with the additional compensation voted and paid. Taxpayer's books were kept on the accrual basis. (R. 10.)

The Commissioner of Internal Revenue disallowed the deduction of the extra compensation totaling $48,000 as an expense for the year 1920. (R. 11.)

The Board of Tax Appeals took the view that the extra compensation was intended as salary for the year 1920, but that the impelling influence in determining the amount to be paid was the services rendered prior to that year. (R. 12.)

In the Circuit Court of Appeals, the Commissioner took the position that the extra compensation so voted was in consideration of services rendered in years prior to 1920 and not for 1920 services. The court accepted this view of the facts, the opinion reading as follows (R. 35):

> First, to say that the additional compensation voted to the company's president and treasurer in 1920 was intended to be as and for, and was as and for, salaries for the year 1920, is to torture the very language of the resolutions themselves. The payment to each officer is expressly stated to be "extra

compensation for his past services," not merely measured *by* such services. The wording could scarcely be clearer.

There appears to be no evidence to sustain the view of the Board that the extra compensation was intended as 1920 salary, and the Board's conclusions in that respect are not only contradicted by the resolution of the board of directors already quoted, but also by evidence introduced by the taxpayer. A letter of Mr. Coblentz, one of the directors (R. 26), shows that he believed that the compensation was for past services, and an examination of the testimony of Mr. Crawford, another director (R. 27–29), confirms that conclusion.

Adopting the view that the compensation was for services performed in prior years, it is conceded on behalf of the Commissioner that the payments were reasonable for such services. The sole question is, therefore, whether they were ordinary and necessary expenses deductible in 1920. It is that question which was decided adversely to the Commissioner by the Circuit Court of Appeals.

If the deduction is disallowed, the resultant increase in tax for 1920 will amount to $24,091.60. (R. 15.)

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in deciding that, where taxpayer's books were kept upon the accrual basis, compensation paid to officers of taxpayer corporation in 1920 (pursuant to resolutions

of board of directors passed in that year) for services rendered in prior years was deductible in 1920 as an ordinary and necessary expense in carrying on the business in determining income and excess-profits taxes for that year.

SUMMARY OF ARGUMENT

It has been the intention of Congress in enacting income tax legislation that the tax be levied upon the taxpayer's true net income for the prescribed accounting period. *United States* v. *Anderson*, 269 U. S. 422. In order to carry out that intent, Section 212 (b) of the Revenue Act of 1918 provided that net income be computed in accordance with taxpayer's regular method of accounting, if that method clearly reflected income; but that if it did not, the computation was to be made upon such basis and in such manner as in the opinion of the Commissioner did clearly reflect income.

In the present case taxpayer seeks the deduction for the year 1920 of extra compensation paid to two of its officers for services rendered over a period of years prior to 1920. The extra compensation was not voted until 1920. There was no agreement that such extra compensation be paid, and until voted by the board of directors there was no basis for any claim therefor.

The Circuit Court of Appeals held that the extra compensation could be deducted by the corporation as an expense in 1920 because it was voted in that

year. The court based its decision upon the theory that since taxpayer's books were on the accrual basis the liability must accrue and be deductible in the year in which all of the factors material to the liability became fixed.

It is true that under the accrual basis deductions may not always be attributed with complete accuracy to the year in which they naturally belong. Some leeway must be allowed as a practical necessity, and some overlapping from year to year is bound to occur if that basis is to be applied consistently. These necessary variations, however, usually adjust themselves over a period of years.

But there is a limit to the diversion of income or deductions from year to year beyond which a taxpayer may not go, even though the technical requirements of the accrual basis are complied with. Beyond this point, the clear reflection of income must govern as provided in Section 212 (b), *supra*.

In the present case the extra compensation not only bore no relation to the year 1920, but should have been allocated to the several years in which the services were rendered instead of being concentrated in a single year. Delay by the board of directors is the only reason why it was not so allocated. Under these circumstances, the deduction is not allowable in the year in which voted, because the true income for that year would not be clearly reflected. See *W. S. Bogle & Co.* v. *Commissioner* (C. C. A. 7th), 26 F. (2d) 771, 772; *Model Dairy,*

Inc., v. *Commissioner* (C. C. A. 8th), decided December 10, 1929, not yet reported (Appendix, p. 21). This view is consistent with the congressional intent that taxes be levied upon the true net income. *United States* v. *Anderson, supra.* See also *De Loss* v. *Commissioner* (C. C. A. 2d), 28 F. (2d) 803, 805.

Arbitrary shifting of deductions from year to year enables the taxpayer to escape the full tax intended to be levied and interferes with the accomplishment of the intention of Congress to levy taxes in accordance with the present needs of the Government.

It is urged, therefore, that the extra compensation is not properly allowable as a deduction in the year 1920.

ARGUMENT

The Circuit Court of Appeals in the present case decided that the taxpayer was entitled to deduct as an ordinary and necessary expense in 1920, extra compensation, voted to its officers in 1920, for services performed during a period of years prior to the year 1920. The regular annual salaries of the two officers for 1920 were $12,000 and $15,000, respectively. (R. 10.) The regular salaries paid to the same officers in prior years never exceeded those amounts, and the same salaries were paid in the succeeding year. The extra compensation to each in 1920 was $24,000. Normally, this extra compensation would have been voted and paid to the officers and deducted as an expense in the several years

during which the services were rendered. The board of directors, however, failed to appropriate the extra compensation until 1920. There was no agreement that the extra compensation was to be paid, and, until voted by the board of directors, there was no basis for a claim therefor on the part of the officers.

The Circuit Court of Appeals held that since the corporation's books were kept on the accrual basis, and the extra compensation was not voted by its board of directors until 1920, an application of the rule that expenses will not accrue until all of the factors material to the liability have become fixed necessitated the conclusion that such compensation accrued as an expense and was deductible in 1920, although the court recognized that it was paid for services rendered in prior years.

The court, however, fails to take into consideration the requirement of Section 212 (b) of the Revenue Act of 1918, *supra,* to the effect that net income shall be computed according to taxpayer's regular method of acounting, if that accounting method clearly reflects income; but that if it does not, the computation is to be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect income.

For the convenience of the Court, the relevant provisions of Section 212 (b), *supra,* are repeated here as follows:

> The net income shall be computed * * * in accordance with the method of accounting

> regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

It is true that the consistent application of the accrual basis of accounting at times necessarily results in the taxing of income or the allowance of deductions in years to which such income or deductions would not otherwise be attributable. There is bound to be some overlapping from one year to another, and deductions may not always be attributed with complete accuracy to the year in which they may naturally belong. In most instances, however, these necessary variations adjust themselves over a period of years, and some leeway must be allowed as a practical necessity.

But there must be a limit to the diverting of income or deductions from one year to another beyond which a taxpayer may not be permitted to go, even though the requirements of the accrual basis may be technically complied with. Beyond that limit, the clear reflection of income must govern as provided in Section 212 (b), *supra*. The purpose of the provision relating to the clear reflection of income is to enable the Commissioner to carry out as nearly as may be the basic principle of the income tax laws, which is to levy a tax upon the true net income for the taxable year.

In the present case, the extra compensation not only bore no relation to the year 1920, but it involved payments in that year which normally would be fixed and incurred in each of the several years during which the services were rendered.

The delay until 1920 was due to the failure of the board of directors to vote the additional compensation in the years in which it was earned. There is no reason why appropriations could not have been made in each of the several years during which the services were rendered at least approximating their value. To allow the deduction to be concentrated in 1920 is to prevent the determination of the true net income for that year, and the cause of the departure from basic principle is the voluntary and avoidable delay on the part of the taxpayer.

The reasoning here advanced is supported by the decision of the Circuit Court of Appeals for the Seventh Circuit in the case of *W. S. Bogle & Co.* v. *Commissioner,* 26 F. (2d) 771. The court said, in its opinion (p. 772):

> Where a salary has been fixed and fully paid for one year, it can not be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year.

The court in the instant case recognized that there is at least a *prima facie* conflict with the *Bogle case,* but suggested that since in the *Bogle case* the court spoke of a salary "fixed and fully paid," there may be implied from that statement

the fact that the additional compensation was unreasonable. Nothing in the *Bogle* opinion suggests such a basis for the decision, and the opinion in the present case conceded the suggested distinction to be a doubtful one. (R. 37–38.) In the present case the regular salaries were accepted by the officers prior to 1920, and the extra compensation granted was entirely voluntary and not based upon prior agreement or present consideration.

The position of the Government in the instant case is consistent with the principles laid down by this Court in *United States* v. *Anderson,* 269 U. S. 422. In that case the Court had occasion to construe the provisions of the Revenue Act of 1916 which correspond to Section 212 (b) of the Revenue Act of 1918. There it was held that a munitions tax imposed for the year 1916 and payable in 1917 was an incurred liability for 1916 and must be deducted by the corporation, accounting on the accrual basis, from gross income of 1916, like other items of expense chargeable to the income of that year. The Court, considering the purpose of Congress to tax actual net income, recognized that if the true net income reported upon the accrual basis is to be clearly reflected there must be deducted from the gross income of the year all the expenses incurred during the year and attributable to the process of earning the income against which they are charged. The language of the Court is as follows (p. 437):

> While Section 12 (a) taken by itself would appear to require the income tax return to be made on the basis of actual receipts and disbursements, it is to be read with Section 13 (d) * * * by providing in substance that a corporation keeping its books on a basis other than receipts and disbursements, may make its return on that basis provided it is one which reflects income.

The Court further said (p. 439):

> Treasury Decision 2433 * * * recognized the right of the corporation to deduct all accruals * * * made on its books to meet liabilities, provided the return included income accrued and, as made, reflected true net income.

And again (p. 440):

> A consideration of the difficulties involved in the preparation of an income account on a strict basis of receipts and disbursements * * * indicates with no uncertainty the purpose of Sections 12 (a) and 13 (d) * * * to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.

> The appellee's true income * * * could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year.

The Court added (p. 441):

> In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the [munitions] taxes had accrued. It should be noted that Section 13 (d) makes no use of the words "accrue" or "accrual" but merely provides for a return upon the basis upon which the taxpayer's accounts are kept, if it reflects income * * *. We do not think that the Treasury decision contemplated a return on any other basis when it used the terms "accrued" and "accrual" and provided for the deduction by the taxpayer of items "accrued on their books."

In *American National Co.* v. *United States,* 274 U. S. 99, this Court again stated and applied the principle announced in the case last cited. Thus this Court has explicitly interpreted the basic purpose of the Revenue Acts and declared the controlling principle applicable to claimed deductions from gross income.

It is this fundamental principle of taxing the true net income which the Circuit Court of Appeals for the Fourth Circuit has failed to recognize and give effect in the instant case. The additional salaries

authorized by the respondent in 1920 were for services rendered in years prior thereto, and certainly were not expenses logically attributable to the year 1920. The Circuit Court of Appeals, however, assumed that since there could be no deduction until all the events occurred that fixed the liability, it must necessarily follow that the happening of all the events authorizes a deduction. It is urged, for the reasons already stated, that the premise adhered to so rigidly by the Circuit Court of Appeals must give way to the statutory requirement of a clear reflection of income, and the basic principle of taxing the true net income, in cases where the concentration of deductions in a single year not only prevents the taxation of the true net income, but finds no basis in practical necessity.

An expression of this principle is found in the opinion of the Circuit Court of Appeals for the Second Circuit in *De Loss* v. *Commissioner,* 28 F. (2d) 803. The court said (p. 805):

> Although it is, of course, true that anyone is entitled to spread his losses as best he can in order to reduce his taxes, in interpreting the law we are not to assume that a system based upon yearly gains and losses was so contrived as to admit deviations in principle which must always operate to the taxpayer's advantage.

In the case of *Model Dairy, Inc.,* v. *Commissioner of Internal Revenue,* decided December 10, 1929 (Appendix, p. 21), the Circuit Court of Appeals for

the Eighth Circuit declined to follow the decision of the Circuit Court of Appeals for the Fourth Circuit in the instant case and, construing the literal language of the statute, held that the services paid for must have been actually rendered in the year for which the allowance is claimed. It is not necessary to go so far in this case, however, since it may be decided on the principle that the incurrence of an expense must have a normal relationship in point of time to the benefit represented by the expenditure, or, to state it differently, that the taxpayer's method of accounting must reflect, and not distort, its net income.

The result of the Government's position here, coupled with that taken by it in *Robert H. Lucas, Commissioner,* v. *American Code Company, Inc.,* No. 67, October Term, 1929, is that under the particular facts of this case the taxpayer has placed itself in a position where no deduction can properly be allowed in any year. While it may seem a hardship to deny a deduction for an expense which perhaps might have been taken had the taxpayer in the earlier years authorized the increased salaries (*cf. Naitove & Co.* v. *Commissioner,* 32 F. (2d) 949, certiorari denied, October 21, 1929), the Revenue Acts must be applied to facts as they actually occur, without reference to what might have been done had the facts been different. There are many cases in which the tax liability varies according to the form that the transaction actually takes.

It is of the greatest practical importance that the arbitrary shifting of deductions from one year to another be prevented. If a corporation were allowed to do so, it would be easy for its board of directors to concentrate deductions in the year in which the corporation might derive the greatest benefit through reduction of taxes. In the period during which excess profits taxes were levied, if deductions were shifted from years in which small profits were earned to years in which the profits were large a substantial saving would result through avoiding taxation at the higher classification in the graduated rates. In any period of changing rates, whether increasing or decreasing, similar results may be accomplished for the benefit of the corporation or its officers.

Moreover, the requirement for an annual accounting of the true income has a more fundamental basis. Taxes and tax rates are based as nearly as may be upon the needs of government. During the period of the war the need was great, and we find excess and war profits taxes, surtaxes, and, in general, graduated rates applied to larger incomes. When the need passed, excess and war profits taxes were eliminated and graduated rates reduced. If Congress intends to adjust taxes to the needs of government, its intention must fail of its best accomplishment unless regular accounting periods are adopted and arbitrary shifting of income or deductions is prevented.

It must be admitted that cases involving questions similar to that in the present case have not received consistent treatment. In an opinion which appears in C. B. VI–1, January–June, 1927, p. 205, Mr. Gregg, then General Counsel, Bureau of Internal Revenue, took the view here asserted by taxpayer, referring to several decisions of the Board of Tax Appeals in which the Commissioner of Internal Revenue acquiesced. See *Appeal of Flint River Brick Co.*, 2 B. T. A. 31; *Appeal of Lihue Plantation Co., Ltd.*, 2 B. T. A. 740, and others. In those cases, however, the Board seems to have reached its conclusion upon the theory that the salaries were reasonable in the year in which deducted although measured on the basis of services rendered in prior years, and has continued to apply this theory in some later cases. *Roubaix Mills, Inc.*, v. *Commissioner*, 7 B. T. A. 878; *Rock Island Sash and Door Works* v. *Commissioner*, 13 B. T. A. 635.

On the other hand, in cases where it was clear that additional salaries were paid in later years expressly for services rendered in prior years—similar to the "extra compensation for * * * past services" here involved—the Board has held in favor of the present contention of the Commissioner, and refused to allow the deduction. See *Appeal of H. T. Cushman Manufacturing Co.*, 2 B. T. A. 39; *Appeal of Green Oil Soap Co.*, 3 B. T. A. 467; *Appeal of W. S. Bogle & Co.*, 5 B. T. A. 541, 551 (affirmed, C. C. A. 7th, 26 F. (2d)

771), *supra; Wise Realty Corp.* v. *Commissioner*, 5 B. T. A. 796; *Vaughan & Barnes, Inc.*, v. *Commissioner*, 6 B. T. A. 1279; *Adams, Payne & Gleaves, Inc.*, v. *Commissioner*, 9 B. T. A. 1076 (affirmed *per curiam*, C. C. A. 4th, 31 F. (2d) 1006); *Model Dairy, Inc.*, v. *Commisisoner*, 13 B. T. A. 545 (affirmed, December 10, 1929, C. C. A. 8th, not yet officially reported), *supra*.

CONCLUSION

For the reasons stated, it is urged that the Circuit Court of Appeals erred in allowing the extra compensation to be deducted as an ordinary and necessary expense in 1920, and the decision of that court should therefore be reversed.

Respectfully submitted.

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JANUARY, 1930.

APPENDIX

UNITED STATES CIRCUIT COURT OF APPEALS, EIGHTH CIRCUIT

No. 8482.—November Term, A. D. 1929

Model Dairy, Incorporated, appellant,

vs.

Commissioner of Internal Revenue, appellee

On petition to review decision of the United States Board of Tax Appeals.

Mr. Benjamin H. Flesher for appellant.

Mr. John H. McEvers, Special Assistant to the Attorney General (Mrs. Mabel Walker Willebrandt, Assistant Attorney General; Mr. J. Louis Monarch, Special Assistant to the Attorney General; and Mr. C. M. Charest, General Counsel, Bureau of Internal Revenue, on the brief with him), for appellee.

Before KENYON and VAN VALKENBERG, Circuit Judges, and MARTINEAU, District Judge.

MARTINEAU, District Judge, delivered the opinion of the court.

This is a petition to review the decision of the United States Board of Tax Appeals. In 1919 the Model Dairy was incorporated for the purpose of handling dairy products, and in that year com-

menced business. Its business had formerly been carried on by two competing partnerships composed of five members, all of whom became officers in the new company. Salaries for 1920 and 1921 were fixed and paid to these officers under a resolution which provided that additional salaries would be paid at some future time if the company prospered. In March, 1922, a resolution was passed fixing and allowing back pay or adjusted compensation to these officers in the sum of $11,940.00, for each of the years 1920 and 1921. The amount allowed for 1920 was to be and was paid in 1922, and the back salary for 1921 was paid in 1923. These increases ranged from sixty to one hundred per cent of the salaries which had been allowed and paid in 1920 and 1921. There was also an increase in the salaries for the years 1922 and 1923, but it was not intended that the $11,940.00 was to be a part of the salarics for these years. The resolution authorizing the payment of these amounts is clear that they were intended as additional compensation or a bonus for the years 1920 and 1921.

In determining the company's income tax the Commissioner of Internal Revenue refused to allow deductions for these back salaries, either for the years in which they were paid or for the years of 1920 and 1921, and the Board of Tax Appeals has upheld that finding. The petitioner here contends that these deductions should be allowed in determining the income tax for 1922 and 1923.

Where a corporation authorizes the payment of money to its officers or employees as additional or adjusted compensation for services rendered during previous years, where there was no understanding or agreement to pay any fixed amount, or any

amount at all, are amounts thus allowed deductible in determining the net income of a corporation?

The answer to this question must be found in the construction of Section 234 of the Revenue Act of 1921, which provides that in computing the net income of a corporation there shall be deducted "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered." This provision authorizes deduction for salaries and other compensation for personal services only when actually rendered during the taxable year. To say that the phrase "during the taxable year" modifies only that part of the section preceding it, and has no reference to salaries and compensation for personal services is to give it a meaning which is clearly contrary to the language actually used. The deductions allowable were to include the ordinary and necessary expenses paid or incurred, together with salaries and other compensation for personal services actually rendered during the taxable year. Language more clearly expressing this meaning could scarcely be selected. The language used was intended to prevent deductions such as those claimed here. In *W. S. Bogle & Company* v. *Commissioner,* 26 Fed. (2d) 771, the court took this view, saying:

"This statute was intended to allow ordinary and necessary expenses paid and incurred within the year for officers' salaries. Where the salary has been fixed and fully paid for one year it can not be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year."

We are not unmindful that a different conclusion was reached in *Ox Fibre Brush Company* v. *Blair, Commissioner,* 32 Fed. (2d) 42. We are of the opinion, however, that a proper construction of the statute justifies the conclusions herein expressed.

The decision appealed from is sustained.

Filed December 10, 1929.

A true copy.

Attest:

[SEAL.] E. E. KOCH,

Clerk, U. S. Circuit Court of Appeals,
Eighth Circuit.

U. S. GOVERNMENT PRINTING OFFICE: 1930

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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1929.

No. 250

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

OX FIBRE BRUSH COMPANY,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

ANSWER TO PETITION FOR WRIT OF CERTIORARI.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A. D. 1929.

No. 250.

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

OX FIBRE BRUSH COMPANY,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

32 Fed. (2d) 42.

ANSWER TO PETITION FOR WRIT OF CERTIORARI.

Respondent respectfully submits that this is not a case for *certiorari*, for the following reasons:—

1. **Uniformity of decision is maintained by upholding the decision of the Court of Appeals.**

The decision below was correct and was in accordance with the rulings of the Bureau of Internal Revenue, with the decisions of the Board of Tax Appeals, and with the decisions of the courts.

(The one court decision which petitioner relies upon as the exception, and therefore, as creating a conflict in the Courts of Appeal, we believe, and shall show, is not an exception.)

2. **Public Importance is not Involved.**

The question sought to be raised is not so obscure, complicated or important as to require further review. *Magnum Import Co.* v. *Coty*, 262 U. S. 159, 163, is in point.

3. **The suggested question is not necessarily involved.**

The question sought to be raised is not necessarily or properly presented by this record.

STATEMENT.

This case arose because the Commissioner of Internal Revenue disallowed as deductions from taxable income of the Ox Fibre Brush Co., respondent, for the year 1920, two amounts of $24,000, accrued and paid in that year as salary to its President and Treasurer, respectively.

The Company appealed from this disallowance (and his proposed additional assessment) to the Board of Tax Appeals, which sustained the Commissioner. Thereupon the Company appealed to the Court of Appeals for the Fourth Circuit; and that Court reversed and held erroneous the Commissioner's disallowance of the payments and sustained them as proper deductions. (*Ox Fibre Brush Co.* v. *Blair Comr., etc.*, 32 Fed. (2d) Sec. 42.)

The Petition admits (pp. 2, 5) that the above amounts were in fact paid for services actually rendered, and not as a distribution of dividends or earnings, and also that the amounts were reasonable.

The officers in question, together with their families, owned only 36% of the stock of the corporation. (32 Fed. 2d, p. 44, 2d column.)

The resolution of the Board of Directors, of 1920, stated that the amount to be paid was "* * * as extra compensation for his past services to this Company."

No doubt as to the good faith of the transaction is intimated by the Petition; and the Court of Appeals expressly

finds that "the company's board of directors unanimously declared *in good faith* that the services rendered were worth the additional compensation." (32 Fed. (2d) p. 48.)

If the compensation in question be considered as salary for the year 1920 alone, it is entirely in line with and in reasonable proportion to the services rendered, business done and earnings accrued for that year.

This was pointed out in the opinion of the Circuit Court of Appeals (R. 56, 32 F. (2d) 42, 48) 32 Fed. (2d) pp. 43-4, where the amounts of annual earnings, expenses and salaries are classified, and the salaries for 1920 are shown to be 5.8 per cent of the gross income; and "the net income in 1920, "namely $158,753.67, after deduction of all expenses includ-"ing officers' salaries represented a return of 21.13 per cent "on invested capital of $751,038.31 as determined by the "Commissioner of Internal Revenue for that year."

Memorandum of Argument.

1. The Decisions of the Court of Appeals Is in Accord with the Uniform Previous Decisions.

A corporate taxpayer, in calculating its net taxable income, may deduct from gross income "a reasonable allowance for salaries or other compensation for personal services actually rendered" to the corporation (1918 Revenue Act, Sec. 234 (*a*) (1)).

(Distributions of corporate profits, whether by formal dividend or otherwise, are not deductible.)

It is submitted that upon the facts the sole test of the corporation's right to deduct these payments is that the amounts in question be reasonable for services actually rendered, and not a distribution of profits.

The amounts of these compensations were not and could not be accrued until the year 1920. There had been no de-

termination to pay any such additional compensation prior to the year 1920, therefore no liability to pay; and necessarily, the amounts could not have been accrued and deducted prior to 1920.

(Opinion, C. C. A. R. 53, 32 Fed. 2d, p. 46):

> "But a salary can neither be 'incurred,' nor can it have 'accrued' until the payor's liability for the same has been fixed, that is, until the company, in the present case, has voted it payable."

The Board of Tax Appeals in this case and the Circuit Court of Appeals, both held that the salaries were accrued in 1920.

A. Assuming that the compensation in question was for services rendered prior to and during 1920, it is clearly deductible as the decisions uniformly hold.

The obligation to pay the compensation was first incurred in 1920, and was an accrual in 1920, and was, therefore, in accordance with the accrual method of bookkeeping pursued by respondent. The money has in fact been paid out by respondent for services and not as distribution of profit; and unless it is allowed as a deduction, the net income for that year will not be truly reflected in accordance with Section 212 of the Revenue Act of 1918.

The provisions of the statute allowing such deductions (Section 234 (*a*) (1) of the Revenue Act of 1918) is as follows:

> "All ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, * * *."

The section does not read, "actually rendered *during the taxable year.*" The statute imposes no such restriction.

In the very nature of things, payments for services are practically always for past services. The Board of Tax Appeals has repeatedly held that additional compensation for services rendered in prior years is deductible in the year in which the compensation is voted and paid. This provides a simple, workable rule. *Flint River Brick Co.*, (2 Bd. Tax Ap. 31); *Lihue Plantation Co.*, (2 B. T. A. 740); *Van de Kamps Holland Dutch Butchers*, (2 B. T. A. 1247); *Arter Paint & Glass Co.*, (2 B. T. A. 1256); *Washington Cadillac Co.*, (2 B. T. A. 844). And, we quote from the opinion of Solicitor Gregg, General Counsel for Bureau of Internal Revenue: "The Commissioner has acquiesced in all these decisions (C. B. IV-2, 2, and C. B. V-1, 4, 6, 1, 6)."

Int. Rev. Bulletin Cum. Bul. VI-1 (January—June, 1927, p. 207.)

It is the Commissioner's refusal to acquiesce in the like ruling in the instant case that breaks the uniformity and the decision of the Court of Appeals that restores it.

To introduce the year the services were rendered as a third element in the test of deductibility would add a serious complication to the tax laws,—and one not provided by the statute. The Commissioner of Internal Revenue acquiesced in all of these decisions of the Board (1925 C. B. IV-1, 2, 3; 1925 C. B. IV-2, 2; 1926 C. B. V-1, 4, 6, 1, 6) and therefore issued a formal ruling to that effect. (*G. C. M.* 941, *Internal Revenue Cumulative Bulletin, Vol.* VI-1, p. 205 (1927)). We quote from pages 207-8:

"Summarizing the foregoing conclusions and specifically answering the three inquiries submitted, it is the opinion of this office that—

(1) In view of the decisions of the Board of Tax Appeals cited by the taxpayer and of the other decisions of the Board involving the same question in which the Commissioner has acquiesced, the additional compensation voted and paid by the taxpayer in its fiscal year

1918 to its president for services performed in 1917 and in prior years is deductible as an expense of the fiscal year 1918;

(2) The ruling in Advisory Tax Board Memorandum 86 that additional compensation voted and paid subsequent to the close of the year in which the services were rendered is not deductible in any year has been modified by the acquiescence of the Commissioner in decisions of the Board of Tax Appeals which hold contrary thereto; * * *."

For Board cases to the same effect decided subsequent to G. C. M. 941, see *Rock Island Sash & Door Works* v. *Commissioner of Internal Revenue,* 13 B. T. A. 635, and cases cited; *Commercial Electrical Supply Company* v. *Commissioner of Internal Revenue,* 8 B. T. A. 986. See also *Rocebaix Mills, Inc.* v. *Commissioner of Internal Revenue,* 7 B. T. A. 878; *Vaughan & Barnes, Inc.* v. *Commissioner of Internal Revenue,* 6 B. T. A. 1279.

We respectfully submit that all of the court decisions are to the same effect.

For a decision holding in accord with the statement of the Circuit Court of Appeals for the Fourth Circuit in the case at bar that compensation for a prior year is deductible in the year in which it is incurred, see *S. Naitove & Co., Inc.* v. *Commissioner of Internal Revenue,* 32 F. (2d) 949, a decision of the Court of Appeals of the District of Columbia affirming a decision of the Board of Tax Appeals which affirmed a determination of the Commissioner of Internal Revenue. Concerning the accrual of additional compensation, the Court of Appeals, at pp. 950 and 951, said:

"Construing the provisions of the income tax law here involved, we are of the opinion that under the accrual system of accounting income may be said to be accrued when it is definitely received, and that likewise liabilities or expenses will be considered to have accrued only when the events have occurred from which liability or

> expense can be determined and fixed, even though payment is not yet due."

For other decisions to the same effect, see *United States v. Block & Kohner Mercantile Co.*, (D. C. E. D. Mo.) 33 F. (2d) 196; and *Wunderle* v. *McCaughn*, (D. C. E. D. Pa.), filed June 5, 1929 (Com. Cl. H. 1929, III Fed. Tax Service, pp. 8652-4), where the court, in discussing the deductibility of compensation allowed in a year subsequent to that in which the services were rendered, said:

> "The defendant (the Collector of Internal Revenue) raises the question that, if it is a bonus, it is not allowable for the year in which it was charged off, but must be prorated over the years during which the services were rendered. This would be true if it had been payable as the result of some legal obligation or promise incurred or made in connection with the employment, but is not true where, as in this case, there is no such obligation existing."

B. The Bogle case not an exception to this uniformity.

Petitioner relies upon the case of *W. S. Bogle & Co.* v. *Commissioner*, 26 F. (2d) 771, C. C. A., 7th Circuit, as contrary, and, as therefore raising a conflict in the Circuit Courts of Appeals. The Circuit Court of Appeals below distinguished the *Bogle* case because of the fact that the court in the *Bogle* case spoke of the salary for previous years as "fixed and *fully* paid * * *, implying, as it would seem, that "the additional compensation rendered the total salary "unreasonable and excessive." Moreover, there was no holding in the *Bogle* case that the additional allowances were reasonable;—while in this case the Court of Appeals devotes a page of its opinion (p. 43) to the facts, and another (pp. 47-8) to the principles applicable thereto, showing that the allowances were reasonable, and that "no testimony whatever was offered on the part of the Commissioner in rebuttal."

The regulations promulgated by the Treasury Department under this provision have adopted this interpretation of the

statute. Article 561 of Regulations 45, under the Revenue Act of 1918, refers to Article 106, which reads, in part, as follows:

> "Compensation for personal Services.—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. *The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.*" (Italics ours.)

This provision has remained unchanged through all the regulations. See Article 106 of Regulations 62 under the Revenue Act of 1921, Regulations 65 under the Revenue Act of 1924 and Regulations 69 under the Revenue Act of 1926, and Article 126 of Regulations 74 under the Revenue Act of 1928. Article 108 of Regulations 45 provides:

> "*Bonuses to Employees*—Gifts or bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are considered gratuities and are not deductible from gross income."

Aside from certain slight changes in wording, this article has also remained the same through all the regulations. See Article 108 of Regulations 62, Regulations 65 and Regulations 69, and Article 128 of Regulations 74.

It is matter of common knowledge that bonuses often are voted and paid after the close of the taxable year. The regulation does not restrict the deduction to bonuses voted and paid during the taxable year. This further confirms the interpretation given the statute by the Court of Appeals.

We respectfully suggest, therefore, that reasonable compensation, *both paid and incurred in the year* 1920, for services actually rendered, even though those services or part of them were rendered prior to 1920, is deductible in 1920.

The previous rulings of the Board of Tax Appeals are uniformly to that effect. These rulings have been acquiesced in and approved by the Bureau of Internal Revenue.

The decisions of the courts are uniformly to that effect. We do not think the *Bogle* case is an exception. If so, it is contrary to the overwhelming weight of administrative precedent and judicial decisions.

There is no distortion of income, and there is no inconsistency with the expressions of this Court in the *Anderson* case.

The Circuit Court of Appeals pointed out the distinction between this case and the case of *United States* v. *Anderson*, 269 U. S. 422. In the *Anderson* case, the munitions tax accrued in 1916 simultaneously with the earnings. The tax liability arose automatically with the earning of the income. In the case at bar, there was no liability until the compensation was authorized and voted by the Board of Directors. Consequently, there was no right to deduct these payments in any year prior to 1920.

2. Public importance is not involved.

The suggestions *contra* are based on the allegation that the decision here conflicts with that in the *Bogle* case, and hence it is alleged *contra* that "the Commissioner is unable to determine the proper principle to be applied." (Petition, p. 7.)

But that alleged conflict does not exist. If any conflict did exist it would be between the Bogle decision standing alone and the several decisions followed by the Court of Appeals in this case.

The *Bogle* case was cited to the court below in this respondent's brief (pp. 10, 25) as in harmony with the others. It was not mentioned in Petitioner's brief there. Such suggestion of conflict comes now for the first time. The Bogle decision is adequately distinguished by the court below (and by the distinctions heretofore indicated herein) as not conflicting either with the other decisions or with the decision herein; and the seeming difference indicated *contra* is not so plain, direct or vital as to constitute a matter of public importance requiring review and correction by this court of last resort.

The suggested difficulty of the Commissioner will readily be avoided by his pursuing the same course which he has pursued in the previous cases, viz., by continuing to acquiesce in the decision, as recited in *Internal Revenue Cumulative Bulletin*, Vol. VI-1, p. 205.

3. **The suggested question is not necessarily involved.**

We respectfully suggest that the question sought to be raised by petitioner is not necessarily or properly presented by the record. The Board of Tax Appeals held not only that the compensation in question was accrued in 1920 but that it was for services in 1920. No error was assigned by petitioner to the holding of the Board of Tax Appeals that the compensation was for the year 1920.

The Board of Tax Appeals held that the additional compensation was unreasonable in amount because it exceeded the amounts paid in prior years. The Circuit Court of Appeals reversed the Board of Tax Appeals in this respect, and held that the compensation was reasonable. Petitioner admits, at Page 5, that the payments were reasonable, based on services performed in prior years. The decision of the Circuit Court of Appeals and this admission, although qualified, eliminates the question of reasonableness from the case, leaving the decision of the Circuit Court of Appeals final in this respect.

It must be accepted, then, that the compensation in this case was *reasonable*. The arguments, therefore, on Pages 10 and 11 of petitioner's brief, that if the decision is sound, a taxpayer may arbitrarily shift expenses, is inapplicable to this case, where the action of the Board of Directors was reasonable. It would be more appropriate for petitioner to raise that issue where the facts show arbitrariness instead of the case where the *facts* show, and the decision finds, reasonableness.

We do not think that the question sought to be raised by petitioner is properly before the Court.

CONCLUSION.

Since the construction of the statute by the Circuit Court of Appeals for the Fourth Circuit in the case at bar gives the reasonable and proper interpretation to Section 234 (*a*) (1) of the Revenue Act of 1918; since the same interpretation has been given to this section by every court which has had the question before it,—by the Board of Tax Appeals and by the Bureau of Internal Revenue, itself; since there is no conflict of decisions of Circuit Courts of Appeals; and since, in view of the state of the record, the statement that the compensation was for services for prior years was unnecessary to the decision of the case, we respectfully submit that the petition for *certiorari* should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1929.

No. 250

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

OX FIBRE BRUSH COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF FOR RESPONDENT.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A. D. 1929.

No. 250

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

OX FIBRE BRUSH COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF FOR RESPONDENT.

STATEMENT OF THE CASE.

Petitioner's statement of the facts relating to the question of whether the additional compensation paid to respondent's president and treasurer in the year 1920 was for services rendered during that year, or whether it was for services performed in prior years, seems inadequate. On this point the United States Board of Tax Appeals specifically found as follows:

> "From all of the evidence adduced, we are of the opinion that the additional compensation voted and

accrued in May, 1920, was intended to be as and for, and was as and for, salaries for the year 1920." 8 B. T. A. 422, 425; R. 12.

To this finding of the Board of Tax Appeals no error was assigned. In the preparation of a statement of the evidence to be used on appeal attention was not directed to the facts bearing upon the question of whether the additional compensation was for services performed in 1920, or for services performed in prior years.

This finding of the Board of Tax Appeals is supported by evidence. Respondent's president and treasurer, in addition to regular duties, rendered special services in the early part of 1920 before the extra compensation was voted. The record states:

> "In the months immediately prior to May 7, 1920, Mr. Robinson and Mr. McEwen both rendered special services to the corporation. That year was a very busy year for both Mr. Robinson and Mr. McEwen, and they had negotiations up with two big plants that wished to sell out, one of them going so far as to make an offer to the Ox Fibre Brush Company to take over the management if it would do so without its paying anything. This was the Brommel Brush & Fibre Industry, located in Cincinnati. The negotiations were dropped in the middle or latter part of April, 1920. It was necessary for Mr. McEwen and Mr. Robinson to travel considerably in connection with these negotiations. They visited the plants in Cincinnati and did other work of that sort relating to the negotiations necessitated in considering this proposition." (R. 25).

The Board of Tax Appeals made the following finding to the same effect:

> "During the early part of the year 1920 the petitioner was negotiating with two large brush-manufacturing concerns relative to purchasing those concerns. These negotiations were dropped in April, 1920, but while pending they necessitated on the part of Robinson and McEwen considerable travelling, visiting of plants and work pertaining to the possible reorganization thereof.

The plants, the purchase of which was under consideration, subsequently failed." 8 B. T. A. 422, 423; R. 9.

The year 1920 was the peak year in dividends. Dividends increased from nothing in 1908 and 1909 to cash dividends of $123,275 and a stock dividend of $300,000 in 1920, thus making a total of $423,275 for that year. (8 B. T. A. 422, 424; R. 11, 28.)

Mr. Crawford, who received his academic training in engineering at the Royal College of Science in Dublin, Ireland; who had been with the General Electric Company, Westinghouse Electric Manufacturing Company, and the Western Electric Company; who had been in charge of the Hawthorne Shops of the Western Electric Company where he had direct supervision over six or seven thousand employees (R. 22); and who knew the market value of the services of repsondent's president and treasurer, testified as to the value of the services of these officers as follows:

"When we took into consideration the services of the men in question, what they had been doing, what the company was when they took it over, what its financial condition was, what its standing was in the art, and then saw how the money we had invested was beginning to bring us in a very substantial return, and how the company had risen to the foremost rank in the business world of brush making; when we saw that we had just received a 50 per cent stock dividend on our stock, we thought that anything less than $24,000 would have been absolutely inadequate, and, besides, we had another project in view: We thought the best way to continue the prosperity that we had enjoyed was to make it worth these men's while to give us the same type of service. We also had one other matter in mind, that we could not get anything like the type and quality of service that the company was getting from these two men at the time, and if we went out into the open market to buy that we would have had to pay far more than their drawing account and the salary accounts of these two men represented." (R. 27.)

"I considered that if we had to go in the open market and hire that kind of services we would have had to

pay $30,000 to $50,000 a year. Those men at that time were not only taking care of the services of Treasurer and President, they were handling all of the large purchases of our company, and they were directing the hiring of the personnel, as you see, by the fact that they hired me. They were directing the policy of the company, and even directing the lines along which factory development should go. They were doing the work of probably five men in addition to the executive duties of President and Treasurer." (R. 27, 28.)

SUMMARY OF THE ARGUMENT.

Petitioner erroneously assumes that the additional compensation voted and paid in 1920 was for services rendered in prior years. The total compensation paid during the year 1920 was no more than a reasonable allowance for personal services rendered during that year.

Under section 234(a)(1) of the Revenue Act of 1918 a taxpayer keeping its books on the accrual basis of accounting may deduct additional compensation for services rendered in prior years in the year in which the additional compensation is incurred. *S. Naitove & Company* v. *Commissioner*, 32 F(2d) 949 (C. A. D. of C., certiorari denied October 21, 1929, 74 L. ed. 57); *United States* v. *Block & Kohner Mercantile Company*, 33 F(2d) 196 (D. C. Mo.); *Green Oil Soap Company* v. *Reinecke*, (D. C. Ill., decided December 18, 1929, not yet officially reported); *Wunderle* v. *McCaughn*, (D. C. E. D. Pa., decided June 5, 1929, not yet officially reported); G. C. M. 941 VI-1 Cumulative Bulletin 205; *Appeal of Van De Kamps Holland Dutch Bakers*, 2 B. T. A. 1247.

Section 212 of the Revenue Act of 1918 has no application to the case at bar for the reason that the income to be accurately reflected is the taxable net income, a statutory concept expressly defined in the statute, not the individual concept of net income entertained by the employees of the Bu-

reau of Internal Revenue. Section 212 refers to the method of accounting and not to the treatment accorded on the books of the taxpayer to an isolated transaction. *Stern* v. *Commissioner,* 13 B. T. A. 1192. In determining the deduction for compensation, and in arriving at the statutory net income, section 212(b) refers directly to section 234(a)(1).

The argument of counsel for petitioner necessitates reading into section 234(a)(1) four words which are not there and which were never intended to be there. They are driven to the extreme contention that the additional compensation in this case is not deductible in any year.

The requirement of section 234(a)(1) that the allowances for services must be reasonable in amount prevents any distortion of income and will go the whole way in eliminating the objections which counsel for petitioner urge against respondent's position.

ARGUMENT.

Petitioner erroneously assumes that the additional compensation voted and paid in 1920 was for services rendered in prior years.

(A) The Board of Tax Appeals found that the additional compensation voted and paid in 1920 was for services rendered in that year, and there is evidence in the record to support its finding.

Respondent's president and treasurer rendered special services in the early part of 1920 in connection with two proposed mergers or consolidations. This work, which was in addition to their regular duties, required an appraisement of the net worth of the companies to be merged or consolidated; an investigation of the earnings of such companies for years prior to the investigation; a consideration of the facts with reference to the location of the plants; the supply of labor available to the plants; the efficiency of the plants for the purposes for which they were being used; whether the particular companies would lend themselves to unity of management and control, and other related questions. An error of judgment or an improper interpretation of any of the many elements might mean disaster.

Of course, in determining the amount of the additional compensation, respondent's board of directors examined the past record of the company and of its president and treasurer. Equally important considerations in the minds of the directors were: (1) the large dividends which had been paid in 1920; (2) the fact that the market value of the services the president and treasurer were rendering was from $30,000 to $50,000 a year each; and (3) that the best way to continue

respondent's prosperity was to make it worth these men's while to give it the same type of service in the future as they had in the past.

No error was assigned to the finding of the Board of Tax Appeals that the additional compensation was as and for salaries for the year 1920. Since this court and the Circuit Court of Appeals for the Fourth Circuit may notice only plain errors where there is no error specified (Revised Rules of the Supreme Court of the United States, Rule No. 27, Subdivision 4; Rules of the United States Circuit Court of Appeals for the Fourth Circuit, Rule No. 11), it is respectfully submitted that this finding of the Board of Tax Appeals has not been preserved for review.

(B) The total compensation, including the $24,000 each paid to respondent's president and treasurer in 1920, was no more than a reasonable allowance for their personal services rendered during that year. The market value of such services as these men were rendering in 1920 was from $30,000 to $50,000 a year each. Further pertinent facts are stated by the Circuit Court of Appeals for the Fourth Circuit (32 F. (2d) 42, 43, 44; R. 33, 34), wherein the court, after reviewing the history of the services of these employees from 1906 forward, pointed out that during 1920 "in addition to their regular executive duties, the president and treasurer handled all large purchases, directed all sales, the hiring of personnel, and also directed the general policies of the company"; that "the percentage of officers' salaries to gross income for 1920 was 5.8 per cent," and that "the net income in 1920, namely, $158,753.67, after deduction of all expenses, including officers' salaries, represented a return of 21.13 per cent on invested capital of $751,038.31, as determined by the Commissioner of Internal Revenue for that year. As a result of the Bureau's disallowance of the $48,000 here in question, the taxable net income for 1920 of the company was $206,753.67 or a return of 27.53 per cent on invested capital and surplus."

The Circuit Court of Appeals, although reaching the conclusion that the extra compensation of $24,000 each voted and paid to the president and treasurer of respondent in May, 1920, was for services rendered in prior years, also found that the total compensation of $75,000 paid to these men in 1920 was but a reasonable allowance for services performed by them during that year (32 F. (2d) 42, 48; R. 40, 41):

> "Adopting, merely for the sake of illustration, the theory of the Board of Tax Appeals that the additional allowances were for services in 1920, the total salaries paid to these officers in that year were $75,000, or less than 6 per cent of the gross income. After deduction of these salaries and all other expenses, the return of stockholders exceeded 33 per cent. While, of course, each case must be determined upon its own peculiar facts, these percentages obviously do not reflect any impropriety in the allowances in question. See *United States* v. *Reitmeyer* (D. C.) 11 F. (2d) 648; *Wood & Ewer Co.* v. *Ham* (D. C.) 14 F. (2d) 995."

For cases in addition to those cited by the court where higher percentages were approved, see *Appeal of Rothholz Examining and Shrinking Co.*, 3 B. T. A. 721 (21 per cent of gross sales); *Appeal of Frank-Sievers Undertaking Co.*, 3 B. T. A. 94 (30 to 33 per cent of gross sales); *Appeal of The Record Abstract Co.*, 2 B. T. A. 628 (30 to 37 per cent of gross sales); *William S. Gray & Company* v. *United States*, Court of Claims, decided December 2, 1929, (40 to 93 per cent of net income before salaries; the court cited many cases with percentages ranging from 46 to 295 per cent, the average being 110 per cent).

This taxpayer keeping its books on the accrual basis of accounting may deduct additional compensation for services rendered in prior years in the year in which the additional compensation is incurred.

Prior to 1920 respondent's president and treasurer were paid fixed yearly salaries. Prior to 1920 they had no claim

to additional compensation. They first received the right to additional compensation, and respondent first incurred liability therefor, on May 6, 1920, when the additional compensation was voted by respondent's board of directors. The liability was not incurred nor did it accrue until that time. This additional compensation was paid during the year 1920. That this additional compensation was not only paid, but also incurred and accrued during the year 1920, counsel for petitioner admit. (Brief 7, 10.)

Counsel for petitioner are driven to the extreme contention that the additional compensation in this case is *not deductible in any year.*

As we understand their argument, it is this, that while a taxpayer keeping its books and rendering its income tax returns under the Revenue Act of 1918 upon the accrual basis of accounting may not deduct a liability until it has been incurred, become fixed and accrued, in the case of the payment of compensation for personal services there may be no deduction unless the services are rendered and the liability to pay therefor incurred in the same year in which the services are rendered. Counsel, in making this argument, rely on section 212 of the Revenue Act of 1918 to the effect that net income shall be computed according to the taxpayer's regular method of accounting if that accounting clearly reflects the income; but that if it does not, the computation is to be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect income (Brief 10, *et seq.*).

This section has no possible application to the case at bar for the reason that the "income" to be accurately reflected is the taxable net income, a statutory concept expressly defined in the statute, not the individual concept of net income entertained by the employees of the Bureau of Internal Revenue. The statutory net income is the gross income as defined by section 233 less deductions allowed by section 234.

In so far as the deduction for compensation is concerned, taxable net income is accurately reflected within the meaning of section 212 (b) if the terms and provisions of section 234 (a) (1) are satisfied, and not otherwise.

Moreover, it is plain from the language of section 212 (b) that it was intended only to authorize the Commissioner to prescribe general accounting methods, which would adequately reflect income. It was not intended to authorize the Commissioner to substitute his individual conception of the proper deductions, in place of those expressly specified in section 234 of the statute. The Board of Tax Appeals has so held. In *Stern Bros.* v. *Commissioner,* 13 B. T. A. 1192, the Board said that section 212 (b) "* * * refers to the method of accounting and not to the treatment accorded on the books to an isolated transaction." Under section 212 (b) the Commissioner may require the taxpayer to adopt a suitable and proper system of accounting, the cash system, the accrual system, possibly a hybrid system in certain cases, or any other system necessary accurately to reflect the taxpayer's statutory net income. In determining the deduction for compensation and in arriving at the statutory net income section 212 (b) refers directly back to section 234 (a) (1).

Section 234 (a) (1) provides in part as follows:

> "Sec. 234 (a). That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, * * *."

Any deduction under this section of the Act cannot distort income, because to be deductible, the salary or other compensation must be an ordinary and necessary expense and must constitute in the aggregate a reasonable allowance

for personal services actually rendered. It seems clear that there can be no distortion of income where the salaries or other compensation paid are necessary expenses and reasonable for the services actually rendered. The very fact that the salaries or other compensation paid are ordinary and necessary business expenses and are reasonable for the services actually rendered necessitates their allowance in computing net income in order *to avoid a distortion by overstating the income.*

We think it will be recognized that usually and generally bonuses and additional compensation are voted and paid in the year subsequent to the year in which the services were rendered. This is due to the fact that a board of directors, in voting bonuses and additional compensation, insist upon having before them the earnings of the corporation, and from the nature of things the earnings are not definitely known until after the end of the year. To construe section 234 as contended for by petitioner would have the effect of not allowing as a deduction for any year bonuses or additional compensation incurred and paid in a year other than the year in which the services were rendered, notwithstanding the fact that the statute specifically allows the deduction of all ordinary and necessary expenses incurred or paid during the year, including a reasonable allowance for salaries or other compensation for services actually rendered. Manifestly, Congress never intended such a result. Furthermore, the result of such a construction would render the making and filing of income tax returns an interminable accounting proposition. If the taxpayer is unable to determine that upon the accrual basis of accounting he is entitled to deduct all liabilities which have been incurred in the year, whether payable at that time or not, it would seem obvious that before taking deductions he would have to seek expert counsel on each item in order to be advised whether the taking of a given deduction might or might not be construed as distorting income. In fact, counsel for petitioner recognize

this fact and are forced to say (Brief 17) that the taxpayer in this case "has placed itself in a position where no deduction can properly be allowed in any year."

We submit that such contentions of the Commissioner are contrary to practically every court decision, to a multitude of decisions of the United States Board of Tax Appeals, to the rulings of the Bureau of Internal Revenue and its Commissioner, which not only stand unrevoked but unmodified, and under which the Bureau of Internal Revenue is acting and on the basis of which it is disposing of cases at the present time.

Section 234 of the Revenue Act of 1918 does *not* read "including a reasonable allowance for salaries or other compensation for personal services actually rendered during the taxable year." It simply reads "personal services actually rendered." The statute imposes no restriction as to the year in which the services must be performed. The test of a corporation's right to deduct such payments is that the amounts are reasonable for services actually rendered. In answering a similar argument made to the Circuit Court of Appeals the court said (32 F.(2d) 42, 45, 46; R. 36, 37):

> "The statute imposes two requirements: First, that the proposed allowance shall be a *necessary* expense, and second, that it shall be reasonable.
>
> • • •
>
> "The statute does not limit its application to services rendered *within the taxable year.*"

There are other court decisions in accord. *S. Naitove & Company* v. *Commissioner*, 32 F. (2d) 949, (C. A. D. of C. certiorari denied October 21, 1929, 74 L. Ed. 57), goes further than necessary to sustain the case at bar. The resolution of the board of directors of S. Naitove & Company voting the additional compensation was passed on February 10, 1919. It was resolved that additional compensation should be paid for the year 1919 to five named individuals, three of

them each to receive ten per cent of the net profits, and two of them each to receive five per cent of the net profits. But it was further provided in the resolution that any and all sums to which these six persons might become entitled under the terms of the resolution should remain in the business at the risk of the business for a period of five years. The court held that the portion of the profits accruing to the six employees under the terms of the resolution was not deductible from the corporation's income in the year in which the services were rendered but was deductible at the expiration of the five-year period. The court said, quoting *Edwards* v. *Keith*, 231 Fed. 110, (C. C. A. 2nd) p. 952:

> "'The statute does not provide that the "personal services," compensation for which is to be considered income, must be rendered in the same year in which the compensation is received. • • •'"

The court added:

> "The decision of the court in the above case is conclusive, we think, of the effect that in a unilateral or conditional contract, as the one here involved, the liability incurred is not to be deducted as expense until it has become fixed and determined, and it is then deductible as of the year when that event occurs—in the instant case, at the expiration of the five-year period."

One of the cases cited and relied upon by the Court of Appeals of the District of Columbia, *United States* v. *Block & Kohner Mercantile Company*, 33 F.(2d) 196 (D. C. Mo.), is similar. In that case the taxpayer corporation, on February 1, 1919, made a contract with an employee in which the employee agreed to work for the company at a salary of $4,800 per annum, payable monthly. In addition, the employee was to receive one-third of the net profits of the taxpayer company during the life of the contract. If net losses resulted from the business, one-third of such losses were to be deducted. One-third of the profits for the year 1919 amounted to $5,193.27, and this amount was credited on the

books of the taxpayer to the employee; but losses for 1920 and 1921 exceeded the profits for 1919, leaving nothing due the employee at the termination of the contract. The taxpayer company sought to deduct from its income for 1919 as expense the amount credited that year to the employee. The court held that this could not be done; that notwithstanding the fact that the services covered by the 1919 credit were rendered during that year, the liability to pay for these services had not been incurred during 1919, and, hence, they were not deductible.

To like effect is *Green Oil Soap Company* v. *Reinecke* (D. C. Ill.), decided December 18, 1929, not yet officially reported, (Ill. C. C. H. Federal Tax Service, 1929, pp. 9904, 9905). The court after quoting at length from the opinion of the Circuit Court of Appeals in the case at hand and from *Edwards* v. *Keith*, 231 Fed. 110 (C. C. A. 2d), continued:

> "The court is of opinion that under the Revenue Act of 1918, as construed by the cases above quoted from and from others cited on the argument, there is no justification for the contention that the deduction for compensation for personal services actually rendered is limited to services rendered within the taxable year."

The court distinguished *W. S. Bogle & Co.* v. *Commissioner*, 26 F.(2d) 771, relied upon by petitioner.

See, also, *Wunderle* v. *McCaughn*, (D. C. E. D. Pa.) decided June 5, 1929, not yet officially reported, (1929, III Commerce Clearing House Federal Tax Service, pp. 8652-8654) where the court said:

> "The defendant (the Collector of Internal Revenue) raises the question that, if it is a bonus, it is not allowable for the year in which it was charged off, but must be prorated over the years during which the services were rendered. This would be true if it had been payable as a result of some legal obligation or promise incurred or made in connection with the employment, but it is not true where, as in this case, there is no such obligation existing."

The Board of Tax Appeals has ruled repeatedly that compensation to be deductible need not be incurred in the year in which the services are rendered. *Appeal of Jamestown Worsted Mills,* 1 B. T. A. 659, Commissioner has acquiesced (IV-1 Cumulative Bulletin 1, 2); *Appeal of Flint River Brick Co.,* 2 B. T. A. 31, Commissioner has acquiesced (IV-2 Cumulative Bulletin 1, 2); *Appeal of Lihue Plantation Co., Ltd.,* 2 B. T. A. 740; *Appeal of Van De Kamps Holland Dutch Bakers,* 2 B. T. A. 1247; *Appeal of Arter Paint & Glass Co.,* 2 B. T. A. 1256; and *Appeal of Washington Cadillac Co.,* 3 B. T. A. 844. The Commissioner acquiesced in all of these decisions. (V-1 Cumulative Bulletin, 1, 4, 6.)

In the *Holland Dutch Bakers* case the Board said, p. 1251:

> "Additional compensation or 'bonus' payments have become, especially since this country entered the World War, a recognized form of salary payment, used for the purpose of retaining the interest of the employee in the business without at the same time incurring any obligation in advance of the payment. Services are performed for salaries which would otherwise be inadequate, the person rendering them expecting to receive such a bonus but the employer being under no obligation to pay it. Such payments also have in them an element looking to future services, the recipient anticipating a further similar payment if the business justifies it.
>
> • • •
>
> "It remains to determine in what year the deduction is to be allowed. Was the obligation incurred in the year when the services were rendered or was it incurred when the additional compensation was voted? Until it was voted there was nothing more than a moral obligation; there was no legal obligation which could be enforced. We must accordingly hold that the $7,000 of additional compensation, voted in 1920 for services rendered in 1919, was an obligation incurred in 1920 and is deductible in that year and not in 1919."

After the Commissioner had acquiesced in several decisions of the Board of Tax Appeals holding that compensation for services performed in prior years was deductible in the sub-

sequent year in which it was incurred, he, through A. W. Gregg, then General Counsel, Bureau of Internal Revenue, issued a formal ruling to the same effect, and revoked a prior inconsistent ruling. G. C. M. 941, VI-1 Cumulative Bulletin 205 (1927). The General Counsel said, pp. 206-208:

> "The material facts in the case under consideration are the authorization and payment in 1918 of compensation for 1917 and additional compensation for prior years and the contention of the taxpayer that the amount is deductible in the return for 1918. * * *"

Reviewing a number of decisions of the Board of Tax Appeals, acquiesced in by the Commissioner, the General Counsel concluded:

> "Summarizing the foregoing conclusions and specifically answering the three inquiries submitted, it is the opinion of this office that—
>
> "(1) In view of the decisions of the Board of Tax Appeals cited by the taxpayer and of the other decisions of the Board involving the same question in which the Commissioner has acquiesced, the additional compensation voted and paid by the taxpayer in its fiscal year 1918 to its President for services performed in 1917 and in prior years is deductible as an expense of the fiscal year 1918;
>
> "(2) The ruling in Advisory Tax Board Memorandum 86 that additional compensation voted and paid subsequent to the close of the year in which the services were rendered is not deductible in any year has been modified by the acquiescence of the Commissioner in decisions of the Board of Tax Appeals which hold contrary thereto. * * *"

Accord: *Commercial Electrical Supply Co.* v. *Commissioner*, 8 B. T. A. 986; *Jerecki Mfg. Co.* v. *Commissioner*, 12 B. T. A. 1165; *Roubaix Mills, Inc.* v. *Commissioner*, 7 B. T. A. 878.

Counsel for petitioner admit in their brief (19) that G. C. M. 941 is in accordance with "the view here asserted by the taxpayer." Not only that, but it stands unrevoked and un-

modified at the present time. It is the ruling under which the Bureau of Internal Revenue is now acting and on the basis of which it is disposing of other cases.

Moreover, the official regulations promulgated by the Treasury Department under Section 234(a)(1) have adopted the same interpretation of that section. Article 561 of Regulations 45, under the Revenue Act of 1918, refers to Article 105, which reads, in part, as follows:

> "Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. *The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.*" (Italics ours.)

This provision has remained unchanged through all the regulations. See Article 105 of Regulations 62 under the Revenue Act of 1921, Articles 106 of Regulations 65 under the Revenue Act of 1924 and Regulations 69 under the Revenue Act of 1926, and Article 126 of Regulations 74 under the Revenue Act of 1928.

Article 107 of Regulations 45 provides:

> "Gifts or bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered."

Aside from certain slight changes in wording, this article has also remained the same through all the regulations. See Article 108 of Regulations 62, Articles 108 of Regulations 65 and Regulations 69, and Article 128 of Regulations 74.

It is a matter of common knowledge that bonuses often are voted and paid in a subsequent year for services performed in a prior year. The regulations in no way restrict the deduction to bonuses voted and paid during the taxable year for services performed during that year.

The converse of the case at bar is compensation paid to the taxpayer for services rendered by him in prior years. In such circumstances the courts hold the compensation taxable to the employee in its entirety in the year received. *Jackson* v. *Smietanka*, 272 Fed. 970 (C. C. A. 7th) affirming 267 Fed. 932 (D. C. N. D. Ill.); *Edwards* v. *Keith*, 231 Fed. 110 (C. C. A. 2nd). It need not be added that the government has collected an income tax for 1920 on the total compensation of these two officers from the individuals.

There are many analogous decisions which support respondent's construction of sections 212 and 234(a)(1). See *Highland Milk Condensing Co.* v. *Phillips*, 34 F. (2d) 777 (C. C. A. 3rd); *Vang* v. *Lewellyn*, 35 F. (2d) 283 (C. C. A. 3rd); G. C. M. 1342, VI—1 Cumulative Bulletin 177; *Western States Envelope Co.* v. *Commissioner*, 10 B. T. A. 856.

The case of *United States* v. *Anderson*, 269 U. S. 422, much relied upon by counsel for petitioner, is easily distinguishable. There it was held that a tax imposed by the Munitions Tax Act of 1916 was a proper accrual for the year 1916 and deductible in that year, though the tax was not required to be paid until 1917; but as was pointed out by the Circuit Court of Appeals for the Fourth Circuit, the events which fixed the amount of the tax and determined the precise amount of the liability all occurred in 1916. From the events that occurred in 1916 the taxpayer in that case knew precisely how much he would be required to pay because of those events. In our case there was nothing of the kind until respondent's board of directors met on May 6, 1920. The matter was put as follows by the Circuit Court of Appeals for the Fourth Circuit:

> "Under the accrual system, an expense accrues when all events have occurred from which liability is determined and has become fixed, even though payment be not yet due. That is to say, the basic idea is that the books shall immediately reflect obligations and expenses definitely incurred, and income definitely earned, with-

out regard to whether payment has been made or is due. This was the theory upon which the case of *United States* v. *Anderson, supra,* was decided. Thus, when in the present case the Government argues that, if a resolution, authorizing additional compensation, be passed subsequent to the year in which the services to be compensated were rendered, the corporation must allocate the payment to the proper years and file amended returns for those years, claiming the deduction in the amended return, it misconceives the basic idea of the accrual plan." (32 F. (2d) 42, 47; R. 39.)

Concerning the case of *W. S. Bogle* v. *Commissioner,* 26 F. (2d) 771 (C. C. A. 7th) affirming 5 B. T. A. 541, also much relied upon by counsel for petitioner, it may be observed that the total compensation was not reasonable for the services performed in the year in which it was paid. In that case the Board of Tax Appeals said, p. 552:

"Since the petitioner claims the deduction in this case for the year in which the additional salary was voted and paid, it must come within the ordinary provisions governing such deductions if it is to be allowed. The petitioner has not shown that the services actually rendered during the year 1917 were such as to make the payment of the full amount, including the amount paid on account of services rendered for prior years, reasonable compensation for the year in which the salary was paid."

To the foregoing statement of the Board of Tax Appeals may be added the statement of the Circuit Court of Appeals for the Seventh Circuit to the effect that "where a salary has been fixed and fully paid for one year, it cannot be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year," thus further implying, as was pointed out by the Circuit Court of Appeals in the case at hand in discussing the *Bogle case,* "that the additional compensation rendered the total salary unreasonable and excessive." 32 F. (2d) 42, 46; R. 38. The same comment on the *Bogle case* is to be found in *Green Oil Soap Co.* v. *Reinecke, supra.*

With reference to the last case especially relied upon by counsel for petitioner, namely, *Model Dairy, Inc.* v. *Commissioner*, C. C. A. 8th, December 10, 1929, affirming 13 B. T. A. 545, a similar distinction must be made. There the Board ended its opinion with the following sentence, page 550:

> "Upon the record here we are unable to determine that total deductions claimed on account of salaries for the years 1922 and 1923 were reasonable compensation for the services rendered."

Counsel for petitioner argue that the delay until 1920 was due to the failure of respondent's board of directors to vote the additional compensation in the year in which it was earned, and say that it results in arbitrary shifting of deductions. The Circuit Court of Appeals for the Fourth Circuit answered this argument as follows, pp. 46, 47:

> "That the practice here sanctioned may be subject to abuse is not sufficient to condemn it. Whether there is actual abuse becomes a question of fact in each case. A corporation with a large surplus in a given year may attempt to dispose of that surplus in the guise of salaries and thereby evade its full tax burden, but there is no evidence that such occurred in the present case; nor is there any bad faith to be deduced from the fact that these officers, together with their families, owned approximately 36 per cent. of the company's stock. The additional compensation was voted to them not because they were stockholders, but because they performed services as employees of the corporation which its board of directors believed to have been peculiarly valuable. If rigid rules of accounting are allowed to supplant that reasonable amount of flexibility which must, from the very nature of things, go hand in hand with the vicissitudes of business, loyalty and ambition on the part of employees will become deadened, and those persons whose services are essential to the success of a given enterprise will be unavailable at the very time when they are most needed. For a corporation to defer payment of full compensation to its employees in times of stress, is no different in principle from the deferring of any of its other obligations. Both must be met in due course. Tax laws should aim to encourage, not to oppose, this result, and should be so construed, unless clearly expressive of a contrary intent."

It is important to observe that the requirement that the total compensation must be reasonable in amount for the services rendered will go the whole way in eliminating the objections which counsel for petitioner urge against respondent's position.

With reference to the shifting of deductions counsel for petitioner also mention that during the period of the war the need for revenue was great, and that there were excess and war profits taxes. In this connection we may note that from a tax point of view it would have been to respondent's detriment to postpone until 1920 paying for services rendered during the war years. Admittedly, income and profits tax rates were higher during the war years (1917 and 1918) than they were in 1920; the rates for 1919 and 1920 were the same.

CONCLUSION.

It is, therefore, respectfully submitted that the decision of the Circuit Court of Appeals for the Fourth Circuit should be affirmed.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES.

No. 250.—October Term, 1929.

Robert H. Lucas, Commissioner of Internal Revenue, Petitioner, *vs.* Ox Fibre Brush Company.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

[April 14, 1930.]

Mr. Chief Justice Hughes delivered the opinion of the Court.

The Ox Fibre Brush Company appealed to the Board of Tax Appeals from the determination by the Commissioner of Internal Revenue of a deficiency in the income tax of the corporation for the year 1920. The Board of Tax Appeals sustained the ruling of the Commissioner (8 B. T. A. 422), and this decision was reversed by the Circuit Court of Appeals. 32 F. (2d) 42.

The question relates to extra compensation granted by the directors of the corporation in the year 1920 to the president and treasurer, of $24,000 each. In the income tax return for that year, the corporation deducted these items from the gross income and the Commissioner of Internal Revenue disallowed the deduction. The Board of Tax Appeals held that, if the additional compensation was given for services performed in prior years, it was not deductible in the year 1920; and if, as the Board concluded, it was allowed for services rendered in 1920, it was in excess of reasonable compensation for that year and hence could not be deducted.

The Circuit Court of Appeals found that the conclusion of the Board of Tax Appeals that the additional compensation was allowed for services performed in the year 1920 was without evidence to support it; that the compensation was for past services. It was further decided that the amount of the additional payment was reasonable in the circumstances shown and was deductible in the return for 1920, the year in which it was allowed and paid.

From the facts as found by the Circuit Court of Appeals, it appears that the president of the corporation had been in office from

1906 and its treasurer from 1907. Both of these officers had devoted their entire time to the interests of the corporation. Each year they had personally guaranteed bank loans to the corporation of considerable amounts. In addition to their ordinary executive duties, the president and treasurer had charge of all large purchases, of all sales, and had directed the general policies of the corporation. Prior to their administration, the business of the corporation had been in a chaotic state and had been conducted at a loss, but under their management the gross sales had increased from about $374,000 in 1909 to $1,273,000 in 1920. The net results were changed from an operating loss of about $4,000 in 1908 to net earnings (after deduction of salaries, including the amounts here in question) of about $158,000 in 1920. No dividends were paid until 1910, but dividends were increased from $4,500 in 1911 and 1912 to $423,275 in 1920, represented by a fifty per cent. stock dividend of $300,000 and cash dividends aggregating $123,275, or 25.98 per cent. on the outstanding capitalization at the beginning of that year. The net income in 1920, after a deduction of all expenses, including officers salaries, represented a return of 21.13 per cent. on invested capital of about $750,000, as determined by the Commissioner of Internal Revenue. The corporation had advanced to a leading place in the brush trade. In 1919 and 1920, the president and treasurer had received salaries of $12,000 and $15,000, respectively. In 1918 their combined salaries were approximately $25,000. The record does not disclose what they received in 1915, 1916 and 1917, but in 1914 they together received $16,000; in 1913, $11,000; in the three preceding years, $10,000, and before that time they received $6,000.

On May 6, 1920, the board of directors unanimously voted to pay to each of these officers $24,000, the resolution in each case explicitly stating that it was paid "as extra compensation for his past services to this company as an officer thereof and in any other capacity".

The books of the corporation were kept on an accrual basis, and during May, 1920, proper entry was made crediting the accounts of the president and treasurer with the additional compensation thus voted.

It is unnecessary to review the facts more in detail, as the Government, adopting the view that the additional compensation, as stated in the resolution of the board of directors and as found by the Circuit Court of Appeals, was for services performed in

prior years, concedes on behalf of the Commissioner that the payments were reasonable for such services. The sole question, therefore, which the Government presents is whether these payments were properly deductible in the return for the year 1920.

The statute applicable to the return is the Revenue Act of 1918, c. 18, 40 Stat. 1057. Section 234 (a) of that act provides (*id.* p. 1077):

"Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

"(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, . . ."

The payments in the present instance were actually made in the year 1920. The expenses represented by these payments were incurred in that year, for it is undisputed that there was no prior agreement or legal obligation to pay the additional compensation. This compensation for past services, it being admitted that it was reasonable in amount in view of the large benefits which the corporation had received as the fruits of these services, the corporation had a right to pay, if it saw fit. There is no suggestion of attempted evasion or abuse. The payments were made as a matter of internal policy having appropriate regard to the advantage of recognition of skill and fidelity as a stimulus to continued effort. There was nothing in the income tax law to preclude such action. On the contrary, the payments fell directly within the provision of section 234(a) as a reasonable allowance for compensation for personal services actually rendered. The statute does not require that the services should be actually rendered during the taxable year, but that the payments therefor shall be proper expenses paid or incurred during the taxable year.

It is urged that under Section 212 (b) of the Revenue Act of 1918 (*id.* 1064, 1065) the Commissioner was entitled to disallow the deduction in the return for 1920, upon the ground that if it were allowed the return would not clearly reflect the income for that year. It is said that the basic principle to be applied is that the true net income is to be taxed. Section 212 (b) provides:

"(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year,

as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. . . ."

This section relates to the method of accounting; the Commissioner may make the computation on a basis that does clearly reflect the income, if the method employed by the taxpayer does not. But this section does not justify the Commissioner in allocating to previous years a reasonable allowance as compensation for services actually rendered, when the compensation was properly paid during the taxable year and the obligation to pay was incurred during that year and not previously. In the present instance, the expense could not be attributed to earlier years, for it was neither paid nor incurred in those years. There was no earlier accrual of liability. It was deductible in the year 1920 or not at all. Being deductible as a reasonable payment, there was no authority vested in the Commissioner to disregard the actual transaction and to readjust the income on another basis which did not respond to the facts.

The case of *United States* v. *Anderson*, 269 U. S. 422, is not in point, as there the liability for the munitions tax at a fixed rate had accrued in the earlier year (1916) and was a charge on the business of that year, although the precise amount was ascertained and was payable in 1917. In *American National Company* v. *United States*, 274 U. S. 99, there was a contract providing definitely for the payment. Compare *Lucas, as Commissioner of Internal Revenue* v. *American Code Company*, decided by this Court February 24, 1930.

Judgment affirmed.

A true copy.

Test:

Clerk, Supreme Court, U. S.